SOCIAL SECURITY REFORM

HEARINGS

BEFORE THE

TASK FORCE ON SOCIAL SECURITY

OF THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

HEARINGS HELD IN WASHINGTON, DC: MAY 4, 11, 18 & 25;
JUNE 8, 15, 22 & 29; JULY 13, 1999

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How Uniformity Treats Diversity: Does One Size Fit All?

TUESDAY, MAY 4, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12 noon in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Members present: Representatives Smith, Herger, Collins, Ryan of Wisconsin, Toomey, Rivers, Bentsen, Clayton, and Holt. Also present: Representative Gutknecht.

Chairman SMITH. If the witnesses would like to come to the witness table, we will kick off our meeting.

The Budget Committee Task Force on Social Security will come to order.

Our witnesses today are Lawrence Kotlikoff, Professor of Economics at Boston University, Research Associate of the National Bureau of Economic Research, Fellow of the Econometric Society, and a member of the Executive Committee of the American Economic Association. He served on the President's Council of Economic Advisors, and as a consultant to the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation and Development. His book—a little color here, a great red book—his book, Generational Accounting, describes Dr. Kotlikoff's research on how Social Security will affect current and future generations.

So thank you very much, Dr. Kotlikoff, for being here.

Darcy Olsen is an Entitlements Policy Analyst with the Cato Institute working on Social Security, child care, education, health care and welfare. In particular, she studies the ways of entitlements and how they affect women, children and the poor. She is the author of Greater Financial Security for Women with Personal Retirement Accounts, a Cato Institute briefing paper.

Before assuming her present position at Cato, Ms. Olsen worked as a transitional house manager and drug counselor for the D.C. Coalition for the Homeless, and was managing editor of the Regulation Magazine.

She is a frequent guest on television and radio programs nationwide and has appeared on the Today Show, NBC Nightly News, and CNN. Her articles and editorials have been published in a variety of newspapers, magazines and journals. Ms. Olsen holds a bachelor's degree from the School of Foreign Service at Georgetown

University, and a master's degree in International Education from New York University.

Thank you for being here.

And Kilolo Kijakazi has been a Senior Policy Analyst for the Center on Budget and Policy Priorities since 1997. Prior to that, she worked for the United States USDA and Urban Institute, and Dr. Kijakazi has a Ph.D. in Public Policy from George Washington University and a master's degree in Social Work from Howard University. Her dissertation, African-American Economic Development and Small Business Ownership, was published in 1997.

So, Dr. Kijakazi, thank you very much for being here.

This meeting today is going to look at some of the transitional costs and, in addition, how it affects different groups of our society, including women, including young people, including the individuals that are not yet in the work force and those that are coming into the work force, as well as married women and the benefits they might expect.

Today's Social Security system has "winners" and "losers." All workers pay the same rate of payroll tax and all retirees receive a benefit based on the same payroll calculation of the payroll benefits that they have paid in, but some workers certainly get a better deal than other workers, and some nonworkers, if they have spouses, get a better deal than some other workers.

Some young workers worry that they may be on the losing end of Social Security benefits, if benefits are cut for future retirees. Understanding how Social Security treats people differently I think will help this Task Force move ahead with solutions that are going to be equitable and fair.

[The prepared statement of Chairman Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Today's Social Security system has winners and losers. All workers pay the same payroll tax and all retirees receive a benefit based on the same payroll calculation—but some workers get a better deal than others.

As a group, married women get higher benefits compared to the payroll contributions they make because they are eligible for a spousal benefit based on their husbands' wages. In addition, women live longer than men, and the Social Security retirement benefit elderly widows receive is the only income that many of them have. Although women pay 38 percent of all Social Security payroll taxes, they receive 53 percent of the Social Security benefits. Our reforms should recognize the special status that Social Security has given women in the past.

Some young workers worry that they may be on the losing end of Social Security if benefits are cut for future retirees. The Social Security actuaries tell us that the system's cash outflow will exceed receipts in just 15 years. Generation X is asking us to make reforms that increase the rate of return they receive on the tax payments they make to support the system.

Understanding how Social Security treats people differently will help us design a future program to give the best deal to everybody.

Chairman SMITH. We would ask each of the witnesses to make a 5-minute presentation, and your printed testimony will be included in the record. We will make sure that there is ample time for anything that didn't come out in the 5 minutes through the questions. What we do here in Washington sometimes is, we react to questions based on the message we want to convey.

So Dr. Kotlikoff.

STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY, AND RESEARCH ASSOCIATE, THE NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. KOTLIKOFF. Chairman Smith and other distinguished members of the House Budget Committee's Task Force on Social Security, I am honored by this opportunity to discuss with you Social Security's treatment of postwar Americans and the system's contribution to the overall imbalance across generations in U.S. fiscal policy.

I have in my testimony two sets of findings. One is from a study that I did with a number of coauthors on Social Security's treatment of different groups in society born since 1945. The study compares women and men, whites and nonwhites, college-educated and noncollege-educated. It also looks, for each of these groups, within lifetime earnings categories. The study was based on a micro simulation analysis in which we start with a representative sample of the population and use statistical and econometric functions to grow the sample demographically and economically through time—to marry them, divorce them, put them in the work force, unemploy them, have them have children, kill them, etc. One needs to do this kind of analysis in order to really assess Social Security, because Social Security is, in large part, an insurance system where how well you fare depends on your particular outcome.

In the study we pool together the experiences of large groups who fall within these categories and average their outcomes together to get an actuarial assessment of how they are being treated. The bottom line is this: Social Security (the OASI system) does not represent a very good deal for postwar Americans. On average, they are losing 5 cents out of every dollar they earn to the OASI program.

For the middle class, Social Security's lifetime net tax is 7 cents per dollar earned. Measured in absolute dollars, the rich are the biggest losers. On average, the lifetime poor are being treated better than the middle class, women are being treated better than men, whites are being treated better than nonwhites, and the college-educated are being treated better than the noncollege-educated. These differences are not gigantic, but nor are they trivial.

Another way to assess Social Security's treatment of postwar Americans is in terms of the rate of return it pays on its contributions. The rate of return that postwar generations can expect is roughly 1.9 percent on their contributions. We are thus considering a system which is yielding a real rate of return that is less than half of the rate of return you could receive today, if you bought inflation-indexed U.S. Government bonds. Those groups that do better than others with respect to facing lower lifetime net tax rates also earn somewhat higher rates of return than others. There are tables in the testimony that document these results.

The problem, however, with Social Security is not just that it has been providing postwar Americans with an overall bad deal, despite some of the good things that it does in terms of forcing people to save and reducing their risks of certain kinds of outcomes. The problem is that Social Security's generally bad actuarial deal is likely to get lots worse because this is a system which, as you well know, is not going to be able to pay for itself through time.

According to the actuaries at Social Security, to pay for Social Security on an ongoing basis, not just for 75 years, but on an ongoing basis, we need an immediate and permanent 4 percentage point hike in the current 12.4 percentage point OASDI tax rate. This huge requisite tax hike is estimated based on the actuaries' intermediate assumptions. I believe that the intermediate assumptions are overly optimistic. A number of academic demographers and economists feel that way as well, especially on the issue of life span.

So we are talking about a system which is, in present-value terms, broke and needs a major fix. But the testimony points out, and I will just close here, that Social Security is part of a larger set of generational imbalances that are measured through this new system of analysis which is called Generational Accounting. Table 6 shows the alternative policy adjustments needed in order to achieve generational balance, a situation in which future generations pay the same share as current generations of their lifetime labor income in taxes net of transfer payments received.

If we were to raise income tax rates to make sure that our children pay the same tax rates on net as we do, we'd need an immediate and permanent 24 percent increase in income tax rates. This finding comes from a study that was done last spring by the CBO and the Federal Reserve. Although the country's current fiscal situation seems better now than it was last spring, my sense is that the generational imbalance in the U.S. is still quite significant and needs attention immediately to resolve.

[The prepared statement of Mr. Kotlikoff follows:]

PREPARED STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY; RESEARCH ASSOCIATE, THE NATIONAL BUREAU OF ECONOMIC RESEARCH

Chairman Smith and other distinguished members of the House Budget Committee's Task Force on Social Security,

I'm honored by this opportunity to discuss with you Social Security's treatment of postwar Americans and its contribution the imbalance in generational policy.

SOCIAL SECURITY'S TREATMENT OF POSTWAR AMERICANS

I've recently coauthored an extensive analysis of this treatment using a micro simulation model that takes into account the entire panoply of OASI benefits.[1] The study finds that Americans born in the postwar period will, under current law, lose roughly 5 cents of every dollar they earn to the OASI program in taxes net of benefits. Measured as a proportion of their lifetime labor incomes, the middle class are the biggest losers, surrendering about 7 cents per dollar earned. But measured in absolute dollars, the rich lose the most.

Out of every dollar that postwar Americans contribute to the OASI system, 67 cents represent a pure tax. The system treats women better than men, whites better than non-whites, and the college-educated better than the non-college educated.

While the system has been partially effective in pooling risk across households, it offers postwar cohorts internal rates of return on their contributions that are quite low—1.86 percent. This is half the real rate currently being paid on inflation-indexed long-term U.S. Government bonds.

This assessment of the system's treatment of postwar Americans, which is detailed in Tables 1 through 3, assumes current law will prevail in future years. But, as you well know, Social Security faces a major long-term funding crisis. An increase of two-fifths in the system's tax rate is needed to meet benefit payments on an ongoing basis. The magnitude of this tax adjustment is more than twice as large

[1] See Caldwell, Steven B., Melissa Favreault, Alla Gantman, Jagadeesh Gokhale, Thomas Johnson, and Laurence J. Kotlikoff, "Social Security's Treatment of Postwar Americans," forthcoming, Tax Policy and the Economy, NBER volume, Cambridge, Ma.: MIT Press, 1999.

as the requisite tax hike acknowledged in the Social Security Trustees Report under the "intermediate" assumptions!

The reason for the discrepancy is that the Trustees Report looks only 75 years into the future. Although 75 years may appear to be a safe enough projection horizon, Social Security is slated to run major deficits in all years beyond this horizon. The Trustees Report's use of the 75-year truncated projection period explains, in part, why Social Security's finances are again deeply troubled after having been "fixed" by the Greenspan Commission in 1983. Each year that passes brings another major deficit year within the 75-year projection window, and 15 years have now passed since the Commission met.

As painful as a 40 percent tax hike would be, even it could fall short of what is really needed to sustain Social Security without cutting benefits. The demographic and economic assumptions comprising the "intermediate" projections appear to be overly optimistic on at least two counts. First, they assume a slower growth in life span than the U.S. has experienced in recent decades. Second, they assume higher future real wage growth than past experience might suggest.

As Tables 4 and 5 confirm, tax increases of two-fifths or greater or comparable benefit cuts would significantly worsen Social Security's treatment of postwar Americans. As a group, Americans born this year would receive only a 1 percent real return on their OASI contributions.

GENERATIONAL ACCOUNTING[2]

Unfortunately, Social Security's unfunded liabilities are only a portion of the broader set of implicit and explicit fiscal liabilities facing future generations. The best way I know to understand the overall fiscal burden facing our children is through generational accounting.[3]

Generational accounting is a relatively new method of long-term fiscal planning and analysis. It addresses the following closely related questions. First, how large a fiscal burden does current policy imply for future generations? Second, is fiscal policy sustainable without major additional sacrifices on the part of current or future generations or major cutbacks in government purchases? Third, what alternative policies would suffice to produce generational balance—a situation in which future generations face the same fiscal burden as do current generations when adjusted for growth (when measured as a proportion of their lifetime earnings)? Fourth, how would different methods of achieving such balance affect the remaining lifetime fiscal burdens—the generational accounts—of those now alive?

Developed less than a decade ago, generational accounting has spread around the globe, from New Zealand to Norway. Much of this accounting is being done at the governmental or multilateral institutional level. The U.S. Federal Reserve, the U.S. Congressional Budget Office, the U.S. Office of Management and Budget, the Bank of Japan, the Bank of England, H.M. Treasury, the Bundesbank, the Norwegian Ministry of Finance, the Bank of Italy, the New Zealand Treasury, the European Commission[4], the International Monetary Fund, and the World Bank have been or are currently involved, either directly or indirectly, in generational accounting. Generational accounting has also drawn considerable interest from academic and government economists.

WHAT IS GENERATIONAL ACCOUNTING?

Generational accounts are defined as the present value of net taxes (taxes paid minus transfer payments received) that individuals of different age cohorts are expected, under current policy, to pay over their remaining lifetimes. Adding up the generational accounts of all currently living generations gives the collective contribution of those now alive toward paying the government's bills. The government's bills refers to the present value of its current and future purchases of goods and services plus its net debt (its financial liabilities minus its financial and real assets, including the value its public-sector enterprises). Those bills left unpaid by current

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[2] This section draws on "Generational Accounting Around the World," a coauthored paper with Berndt Raffelheuschen forthcoming in the May 1999 American Economic Review.

[3] See Auerbach, Alan J., Laurence J. Kotlikoff, and Willi Leibfritz, eds., Generational Accounting Around the World, Chicago, Illinois: The Chicago University Press, forthcoming 1999. Auerbach, Alan J., Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A Meaningful Alternative to Deficit Accounting," in D. Bradford, ed., Tax Policy and the Economy 5, Cambridge, MA: MIT Press, 1991, 55-110.

[4] The European Commission has an ongoing project to do generational accounting for EU member nations under the direction of Bernd Raffelhueschen, Professor of Economics at Freiburg University.

generations must be paid by future generations. This is the hard message of the government's intertemporal budget constraint—the basic building block of modern dynamic analyses of fiscal policy.

This budget constraint can be expressed in a simple equation: A+B=C+D, where D is the government's net debt, C is the sum of future government purchases, valued to the present, B is the sum of the generational accounts of those now alive, and A is the sum of the generational accounts of future generations, valued to the present. Given the size of the government's bills, C+D, the choice of who will pay is a zero-sum game; the smaller is B, the net payments of those now alive, the larger is A, the net payments of those yet to be born.

The comparision of the generational accounts of current newborns and the growth-adjusted accounts of future newborns provides a precise measure of generational imbalance. The accounts of these two sets of parties are directly comparable because they involve net taxes over entire lifetimes. If future generations face, on a growth-adjusted basis, higher generational accounts than do current newborns, current policy is not only generationally imbalanced, it's also unsustainable. The government cannot continue, over time, to collect the same net taxes (measured as a share of lifetime income) from future generations as it would collect, under current policy, from current newborns without violating the intertemporal budget constraint. The same is true if future generations face a smaller growth-adjusted lifetime net tax burden than do current newborns. However, in this case, generational balance and fiscal sustainability can be achieved by reducing the fiscal burden facing current generations rather than the other way around.

The calculation of generational imbalance is an informative counterfactual, not a likely policy scenario, because it imposes all requisite fiscal adjustments on those born in the future. But it delivers a clear message about the need for policy adjustments. Once such a need is established, interest naturally turns to alternative means of achieving generational balance that do not involve foisting all the adjustment on future generations.

Generational Accounting versus Deficit Accounting

A critical feature of generational accounting is that the size of the fiscal burden confronting future generations (the term A in A+B=C+D) is invariant to the government's fiscal labeling—how it describes its receipts and payments. The same, unfortunately, is not true of the government's official debt. From the perspective of neoclassical economic theory, neither the government's official debt nor its change over time—the deficit—is a well-defined economic concept. Rather these are accounting constructs whose values are entirely dependent on the choice of fiscal vocabulary and bear no intrinsic relationship to any aspect of fiscal policy, including generational policy. In terms of our equation A+B=C+D, different choices of fiscal labels alter B and D by equal absolute amounts, leaving C and A unchanged.

To see the vacuity of fiscal labels, consider just three out of the infinite set of alternative ways a government could label its taking $100 more measured in present value in net taxes from a citizen named Nigel. In each case, r is the interest rate, Nigel's remaining lifetime net-tax payments increase by $100, and there is an additional net flow of $100 to the government from Nigel this year and no additional net flows from Nigel to the government next year.

1. "A $100 tax levied this year on Nigel."

2. "An $800 loan made this year by Nigel to the government less a $700 transfer payment to Nigel, plus a tax levied next year on Nigel of $800 (1+r), plus a repayment next year to Nigel of $800 (1+r) in principle plus interest."

3. "A $5,000,000,000 tax paid this year by Nigel, less a $4,000,000,900 loan to Nigel this year by the government, plus a $4,000,000,900 (1+r) transfer payment next year to Nigel, plus a repayment next year by Nigel of principle and interest of $4,000,000,900 (1+r)".

Compared to case 1's language, using the language in the other cases will generate the following: case 2: a $800 larger deficit, and case 3: a $4,000,000,900 smaller deficit. Although the government's reported deficit is dramatically different depending on how it labels the additional $100 pounds it gets this year from Nigel, Nigel's economic circumstances are unchanged. Regardless of which language the government uses, it's still getting $100 more in present value from Nigel in net taxes, and Nigel's own economic resources are, in each case, depressed by $100. Since Nigel's annual cash flows are the same, alternative choices of language have no impact on the degree to which he is liquidity constrained in choosing how much to consume and save.[5]

Unfortunately, the ability to avoid hard policy decisions by manipulating the reported deficit has not escaped politicians around the world. In the United States in the 1980's this practice was christened "smoke and mirrors." It was exemplified by the government's decision to first put the Social Security system off budget, when it was running deficits, and then to put in on budget, when it was running surpluses. In France and Belgium substituting words for deeds was used in selling the assets of state-owned companies to get enough revenue to fall below Mastrict's deficit limit while maintaining these companies' major liabilities—their unfunded pension plans. In Germany, the Bundesbank had to prevent the Federal Government from revaluing its gold stock to meet Mastrict's deficit limit. These and countless other examples are symptomatic of a much deeper problem, namely, there are no economic fundamentals underlying the deficit and its use is an utter charade. This point is of central importance to you Members of Congress as you consider whether to spend the so-called "surpluses" currently being projected.

GENERATIONAL IMBALANCES AROUND THE GLOBE

Table 6 indicates the size of the generational imbalance in U.S. fiscal policy and compares it with that in 21 other countries. It does so by showing four mutually exclusive ways the 22 countries could achieve generational balance. The alternatives are cutting government purchases, cutting government transfer payments, increasing all taxes, and increasing income taxes (corporate as well as personal). Each of these policies is described in terms of the immediate and permanent percentage adjustment needed. The magnitudes of these alternative adjustments provide an indirect measure of countries' generational imbalances.

The four different policies are considered under two definitions of government purchases and transfer payments. Definition A treats education as a government purchase and not as a transfer payment. Definition B does the opposite. Because of space limitations, I focus on definition B.

According to the second column in the table, 13 of the 22 countries need to cut their non-educational government spending by over one fifth if they want to rely solely on such cuts to achieve generational balance. This group includes the United States and Japan and the three most important members of the European Monetary Union: Germany, France, and Italy. Four of the 13 countries—Austria, Finland, Spain, and Sweden—need to cut their non-education purchases by more than half, and two countries—Austria and Finland—need to cut this spending by more than two thirds!

Bear in mind that generational accounting is comprehensive with respect to including regional, state, local, and Federal levels of government. So the cuts being considered here are equal proportionate cuts in government spending at all levels. In the U.S., where a large proportion of government spending is done at the state and local level, achieving generational balance by just cutting Federal spending would require that spending to be roughly halved. Given U.S. fiscal nomenclature, this means "running" Federal surpluses that are more than $300 billion larger than is currently the case.[6]

Not all countries suffer from generational imbalances. In Ireland, New Zealand, and Thailand future generations face a smaller fiscal burden, measured on a growth adjusted basis, than do current ones given the government's current spending projections. Hence, governments in those countries can spend more over time without unduly burdening generations yet to come. There are also several countries in the list, including Canada and the United Kingdom, with zero or moderate generational imbalances as measured by the spending adjustment needed to achieve perfect balance. What explains these tremendous cross-country differences? Fiscal policies and

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[5] Moreover, the same set of economic incentives Nigel faces for saving or working are provided in all four cases. For example, suppose the government imposes an additional marginal tax rate of *t* on Nigel's current labor income in order to generate the additional $100 pounds in revenue measured in present value. In case 1, this would be described as "a tax at rate *t* on this year's labor earnings." In case 2, it would be described as "a marginal subsidy at rate 7t to this year's labor supply plus a marginal tax on this year's labor supply at rate 8t(1+r) where the payment is due next year." In case 4, it would be described as "a marginal tax of 50t plus a marginal subsidy at rate 49t to be paid next year." In each case, the net marginal income from Nigel's earning an additional pound this year is reduced by *t* times one pound.

[6] These figures, by the way, come from Gokhale, Page, and Sturrock (1999)—a joint study of the Federal Reserve Bank of Cleveland and The Congressional Budget Office (CBO). They incorporate the latest CBO projections of Federal Government spending and receipts and, therefore, of Federal surpluses.

demographics differ dramatically across countries. The U.S., for example, suffers from rampant Federal health care spending. Japan's health care spending is growing less rapidly, but it's aging much more quickly. The United Kingdom has a policy of keeping most transfer payments fixed over time in real terms. Germany is dealing with the ongoing costs of reunification.

One alternative to cutting spending is cutting transfer payments. In Japan, education, health care, Social Security benefits, unemployment benefits, disability benefits, and all other transfer payments would need to be immediately and permanently slashed by 25 percent. In the U.S., the figure is 20 percent. In Brazil, it's 18 percent. In Germany, it's 14 percent. In Italy it's 13 percent.

These and similar figures for other countries represent dramatic cuts and would be very unpopular. So too would tax increases. If Japan were to rely exclusively on cross-the-board tax hikes, tax rates at all levels of government (regional, state, local, and federal) and of all types (value added, payroll, corporate income, personal income, excise, sales, property, estate, and gift) would have to rise overnight by over 15 percent. In Austria and Finland, they'd have to rise by over 18 percent. If these three countries relied solely on income tax hikes, they had to raise their income tax rates by over 50 percent! In France and Argentina, where income tax bases are relatively small, income tax rates would have to rise by much larger percentages. The requisite income tax hikes in the U.S. and Germany are roughly one quarter. In contrast, Ireland could cut its income tax rates by about 5 percent before it needed to worry about over burdening future generations.

The longer countries wait to act, the bigger the adjustment needs to be when action is finally taken. Take the UK. It needs an immediate permanent 9.5 percent income-tax hike, if it wants to achieve generational balance through that channel. But if it waits 5 years, the requisite income tax hike is 11.1 percent. It's 15.2 percent with a 15-year delay, and 21.0 percent with a 25-year delay.

CONCLUSION

Generational Accounting is being done in a large and growing number of countries around the world. Notwithstanding its shortcomings, generational accounting has four major advantages over deficit accounting: It's forward looking. It's comprehensive. It poses and answers economic questions. And, its answers are invariant to the economically arbitrary choice of fiscal vocabulary.

The findings reported here are shocking. An array of countries, including the United States, Germany, and Japan, have severe generational imbalances.[7] This is true notwithstanding the fact that the United States is currently reporting an official surplus, that Germany's reported deficit is within Mastrict limits, and that Japan has the lowest reported ratio of net debt to GDP of any of the leading industrialized countries. The imbalances in these and the majority of the other countries considered in Table 6 place future generations at grave risk.

In the case of the U.S., Social Security's long-term financial imbalance appears to be responsible for between a third and two-fifths of the country's overall imbalance in generational policy. Hence, fixing Social Security's long-term financial problems once and for all should be of the highest priority.

TABLE 1.—AVERAGE LIFETIME OASI NET TAX RATES

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Cohort 45	0.4	5.5	6.7	6.8	7.1	7.1	6.8	5.9	6.0	3.7	5.5
Cohort 50	−2.3	4.1	5.5	6.0	6.4	6.7	6.6	6.3	6.2	3.6	4.9
Cohort 55	−0.9	4.6	6.0	6.4	6.6	7.2	7.4	7.3	6.7	3.9	5.2
Cohort 60	−0.1	5.1	6.4	7.0	7.1	7.3	7.6	7.4	7.5	3.9	5.2
Cohort 65	0.1	5.1	6.3	7.2	7.0	7.1	7.6	7.5	7.3	4.4	5.5
Cohort 70	0.1	4.8	6.2	6.7	7.2	7.2	7.7	7.8	7.5	4.3	5.4
Cohort 75	−0.3	4.6	6.1	6.7	6.9	7.0	7.2	7.4	7.8	4.5	5.4
Cohort 80	−1.0	4.5	5.8	6.6	6.8	7.2	7.0	7.6	7.5	4.6	5.4

[7] The Congressional Budget Office and the Federal Reserve Bank of Cleveland are in the process of revising the U.S. generational accounts in light of recent favorable economic news. The new results are likely to indicate a smaller generation imbalance. However, CBO's most recent baseline budget forecast is based on a very strong and highly questionable assumption, namely that Federal Government discretionary spending will remain constant in real terms over the next 10 years. Assuming a more plausible time-path of government spending could well leave the generational imbalance near the level reported in Table 6.

TABLE 1.—AVERAGE LIFETIME OASI NET TAX RATES—Continued

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Cohort 85	−1.2	4.1	5.7	6.3	6.7	6.8	7.0	7.4	7.6	4.4	5.1
Cohort 90	−1.2	4.0	5.5	6.3	6.7	6.8	7.0	6.9	7.6	4.7	5.3
Cohort 95	−1.8	3.8	5.3	6.1	6.4	6.4	6.7	7.3	7.3	4.9	5.3
Men 45	4.7	6.3	7.2	7.3	7.5	7.3	6.9	6.1	6.6	3.9	5.9
Men 50	3.6	5.4	6.3	6.5	6.7	6.8	7.0	6.5	6.2	3.7	5.5
Men 55	4.0	5.9	6.5	6.9	6.9	7.5	7.7	7.9	7.0	4.0	5.6
Men 60	4.2	6.2	7.2	7.3	7.6	7.6	8.2	7.7	7.7	3.9	5.6
Men 65	4.4	6.1	6.9	7.5	7.4	7.3	7.7	7.5	7.4	4.6	5.9
Men 70	4.4	6.0	6.9	7.0	7.5	7.3	8.0	8.0	7.9	4.6	5.9
Men 75	4.0	5.8	6.7	7.1	7.2	7.5	7.6	8.0	8.1	4.6	5.9
Men 80	4.3	5.3	6.5	7.1	7.1	7.4	7.2	7.8	7.6	5.0	5.8
Men 85	3.4	5.1	6.4	6.8	6.9	6.9	7.4	7.8	8.1	4.4	5.4
Men 90	2.8	4.9	6.1	6.8	6.8	7.1	7.0	7.2	7.9	4.9	5.7
Men 95	1.9	4.6	5.8	6.2	6.8	6.4	6.9	7.5	7.3	5.0	5.6
Women 45	−0.6	4.9	6.0	5.9	6.1	6.1	6.5	5.2	4.1	2.7	4.4
Women 50	−4.3	3.3	4.7	5.3	5.7	6.4	5.6	5.7	6.0	3.3	3.8
Women 55	−3.0	3.6	5.3	5.6	6.1	6.4	6.7	6.4	5.8	3.7	4.3
Women 60	−2.0	4.2	5.7	6.5	6.5	6.9	6.6	7.0	6.9	3.8	4.7
Women 65	−1.8	4.3	5.5	6.7	6.5	6.7	7.3	7.4	7.0	3.9	4.9
Women 70	−2.0	3.9	5.6	6.3	6.6	6.9	7.3	7.3	6.5	3.7	4.6
Women 75	−2.3	3.7	5.5	6.1	6.5	6.1	6.5	6.7	7.2	4.2	4.7
Women 80	−3.3	3.8	5.1	5.9	6.3	6.8	6.8	7.2	7.3	3.9	4.5
Women 85	−3.1	3.4	5.1	5.8	6.3	6.7	6.3	6.7	6.3	4.2	4.6
Women 90	−2.9	3.5	4.9	5.8	6.5	6.6	7.0	6.3	6.9	4.5	4.7
Women 95	−3.3	3.2	4.8	6.0	5.9	6.4	6.5	6.8	7.4	4.7	4.8
White 45	0.3	5.5	6.6	6.9	7.1	7.1	6.9	5.8	5.9	3.7	5.4
White 50	−2.6	4.0	5.5	6.0	6.3	6.7	6.6	6.3	6.2	3.6	4.8
White 55	−1.1	4.5	5.9	6.4	6.5	7.2	7.4	7.3	6.6	3.9	5.1
White 60	−0.3	5.0	6.3	7.0	7.1	7.3	7.7	7.4	7.6	3.9	5.2
White 65	−0.2	5.0	6.3	7.1	7.0	7.0	7.5	7.5	7.5	4.3	5.5
White 70	−0.2	4.6	6.1	6.7	7.2	7.1	7.7	7.9	7.5	4.4	5.4
White 75	−0.3	4.5	6.0	6.7	6.8	6.9	7.1	7.4	7.8	4.4	5.3
White 80	−1.4	4.3	5.8	6.6	6.8	7.1	7.0	7.7	7.5	4.5	5.2
White 85	−1.5	3.9	5.5	6.2	6.7	6.9	6.9	7.4	7.4	4.3	5.0
White 90	−2.0	3.8	5.3	6.3	6.8	6.8	7.0	7.1	7.6	4.7	5.3
White 95	−2.2	3.4	5.1	6.0	6.3	6.3	6.6	7.2	7.3	4.8	5.2
Nonwhite 45	1.3	5.3	7.0	6.4	7.4	6.4	6.2	6.6	7.0	3.8	5.8
Nonwhite 50	−0.3	4.8	5.9	6.0	6.9	7.0	6.4	6.5	6.3	4.1	5.4
Nonwhite 55	0.2	5.3	6.5	6.2	7.1	7.2	7.7	7.6	7.9	4.3	5.6
Nonwhite 60	1.3	5.8	7.0	7.0	7.4	7.5	6.5	8.1	6.9	3.5	5.1
Nonwhite 65	1.9	5.7	6.1	7.2	7.4	7.3	8.1	7.4	5.3	4.8	5.8
Nonwhite 70	1.7	5.4	6.6	6.7	7.1	7.4	7.8	7.4	7.4	4.0	5.4
Nonwhite 75	−0.7	5.1	6.5	6.9	7.3	7.2	7.8	7.7	8.0	4.9	5.9
Nonwhite 80	0.7	5.1	5.9	6.7	6.7	7.4	7.3	7.3	7.9	5.5	6.0
Nonwhite 85	−0.1	5.1	6.3	6.8	6.5	6.6	7.3	7.1	8.3	4.7	5.5
Nonwhite 90	1.3	5.1	6.0	6.4	6.2	6.9	7.3	6.1	7.6	4.7	5.5
Nonwhite 95	−0.5	5.0	6.0	6.5	6.9	6.9	7.0	7.6	7.6	5.5	5.9
Noncollege 45	0.6	5.7	6.9	7.0	7.2	6.8	6.8	5.7	6.4	3.8	5.7
Noncollege 50	−2.0	4.4	5.7	6.2	6.5	6.8	6.5	6.5	6.1	4.0	5.1
Noncollege 55	−0.4	4.7	6.0	6.4	6.5	7.4	7.6	7.3	7.0	4.2	5.4
Noncollege 60	0.3	5.3	6.6	6.8	7.2	7.5	7.6	7.8	7.9	4.2	5.6
Noncollege 65	0.5	5.2	6.4	7.3	7.0	7.2	7.7	7.8	7.6	4.7	5.8
Noncollege 70	0.3	5.0	6.5	6.9	7.2	7.2	7.5	8.0	7.4	4.7	5.7
Noncollege 75	0.3	4.8	6.2	6.5	7.0	7.3	7.2	7.7	8.0	4.8	5.7
Noncollege 80	−0.4	4.8	6.0	6.4	7.0	7.0	6.9	7.6	7.9	5.0	5.6
Noncollege 85	−0.9	4.5	5.9	6.3	6.8	6.9	7.0	7.5	7.4	4.6	5.3
Noncollege 90	−0.5	4.2	5.5	6.4	6.9	6.9	7.1	6.9	7.8	5.2	5.6
Noncollege 95	−0.9	3.9	5.4	6.2	6.7	6.8	7.1	7.6	7.3	5.6	5.7
College 45	−0.2	4.7	6.1	6.5	7.1	7.4	6.9	6.1	5.5	3.6	5.1
College 50	−3.0	3.5	5.2	5.6	6.3	6.6	6.7	6.2	6.3	3.3	4.6
College 55	−2.2	4.2	5.9	6.4	6.7	6.8	7.1	7.3	6.2	3.6	4.8
College 60	−1.0	4.8	6.1	7.2	7.1	7.1	7.6	7.0	7.1	3.6	4.8

TABLE 1.—AVERAGE LIFETIME OASI NET TAX RATES—Continued

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
College 65	−0.6	5.0	6.1	6.9	7.0	6.9	7.4	6.8	6.9	4.1	5.2
College 70	−0.3	4.5	5.9	6.4	7.1	7.1	7.9	7.7	7.6	4.1	5.1
College 75	−1.4	4.3	6.0	6.9	6.8	6.8	7.2	7.2	7.7	4.3	5.2
College 80	−1.8	4.1	5.7	6.9	6.6	7.3	7.1	7.6	7.2	4.4	5.1
College 85	−1.8	3.6	5.4	6.3	6.5	6.8	7.0	7.3	7.8	4.2	5.0
College 90	−2.6	3.8	5.5	6.2	6.5	6.8	7.0	6.8	7.4	4.4	5.1
College 95	−3.4	3.5	5.3	5.9	6.1	6.0	6.4	7.0	7.4	4.6	5.0

TABLE 2.—LIFETIME SOCIAL SECURITY BENEFITS AS A SHARE OF LIFETIME SOCIAL SECURITY TAXES

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Cohort 45	3.47	53.28	67.05	70.61	73.71	75.72	76.88	75.34	77.60	77.20	67.59
Cohort 50	−26.22	46.35	61.26	67.68	70.62	74.54	76.04	76.79	77.60	76.09	64.58
Cohort 55	−9.75	48.31	62.48	67.29	70.36	75.23	77.78	77.98	78.33	78.05	67.03
Cohort 60	−0.98	51.24	63.52	70.26	71.37	73.61	77.41	78.73	79.98	78.64	68.47
Cohort 65	1.06	49.97	61.27	69.79	70.99	72.95	74.64	75.55	79.69	80.18	68.63
Cohort 70	0.93	46.66	60.48	66.49	70.57	71.81	75.41	79.06	77.97	79.79	67.94
Cohort 75	−3.30	45.08	59.98	66.39	68.40	70.07	73.59	74.61	78.97	79.49	67.35
Cohort 80	−9.44	44.24	57.80	65.20	67.69	70.57	70.54	75.24	77.74	79.43	67.47
Cohort 85	−12.13	40.98	55.36	61.82	66.03	68.79	69.75	74.32	77.09	78.42	66.04
Cohort 90	−12.35	39.59	54.43	62.28	66.35	68.66	70.75	71.62	75.37	77.61	65.83
Cohort 95	−18.17	37.01	52.67	59.67	64.04	64.27	67.29	71.66	74.78	78.88	66.19
Men 45	45.08	64.52	72.91	74.38	76.26	77.25	78.26	77.27	79.79	78.88	75.55
Men 50	39.84	60.11	68.09	71.81	73.25	76.40	78.36	78.58	78.47	77.35	73.41
Men 55	42.23	60.71	68.15	71.79	72.59	77.61	80.32	80.63	79.43	79.09	74.47
Men 60	42.02	62.40	69.39	73.47	74.07	75.66	80.79	81.37	80.98	79.42	75.16
Men 65	42.84	59.83	68.20	72.94	74.66	75.39	75.20	76.51	80.69	81.51	75.16
Men 70	43.57	57.88	66.42	69.87	73.43	73.20	77.11	80.16	79.31	80.91	74.42
Men 75	40.64	55.47	66.30	69.74	70.84	73.75	76.65	78.30	80.53	80.74	74.06
Men 80	42.03	53.42	63.66	69.60	70.56	73.49	71.50	76.42	78.38	80.65	73.78
Men 85	33.47	50.42	62.03	65.93	68.60	70.18	73.25	76.36	79.56	79.29	72.43
Men 90	27.90	47.71	60.74	66.78	67.32	70.64	70.66	73.57	76.43	78.43	71.39
Men 95	19.22	44.74	57.40	60.57	67.64	64.90	68.21	72.05	74.81	79.40	70.84
Women 45	−4.81	46.40	59.63	62.72	66.80	68.41	71.56	68.99	68.15	69.04	51.73
Women 50	−49.48	36.76	53.37	60.08	64.38	70.05	69.71	70.60	75.27	71.90	48.64
Women 55	−32.25	39.12	55.87	60.42	66.46	69.48	71.78	73.50	75.42	75.24	54.80
Women 60	−20.21	42.28	56.96	65.64	67.16	70.62	71.68	74.70	77.08	76.74	58.33
Women 65	−17.16	42.11	53.68	65.39	65.55	68.54	73.65	74.14	77.12	76.40	58.23
Women 70	−20.04	37.78	54.54	61.68	65.97	69.38	72.32	76.50	74.62	77.08	57.67
Women 75	−22.28	36.71	54.04	61.30	64.02	64.12	68.67	69.65	74.80	76.52	56.98
Women 80	−32.32	36.91	50.44	58.81	63.70	66.74	69.17	72.42	76.14	76.21	56.95
Women 85	−30.44	33.72	49.90	57.00	62.56	66.56	64.07	70.68	70.75	76.31	56.26
Women 90	−28.78	33.94	48.30	57.10	64.96	66.12	70.95	68.01	72.94	75.76	57.31
Women 95	−32.35	31.31	47.67	58.51	59.41	63.19	65.87	70.64	74.72	77.63	58.60
White 45	2.54	53.13	66.23	70.95	73.58	76.24	76.88	74.98	76.83	77.38	67.50
White 50	−28.90	45.14	60.65	67.78	70.41	74.64	75.99	76.97	77.88	75.94	64.29
White 55	−11.44	47.29	61.94	67.43	69.79	75.18	77.66	77.34	77.95	78.31	66.99
White 60	−3.23	50.26	62.64	70.03	71.55	73.68	77.61	78.46	80.29	78.61	68.34
White 65	−1.91	48.55	61.65	69.86	71.23	72.53	74.45	75.69	80.66	80.27	68.77
White 70	−2.15	45.26	59.79	66.13	70.58	71.51	75.84	79.87	77.45	80.12	67.95
White 75	−2.61	44.05	59.57	66.13	67.92	70.11	72.94	74.21	78.61	79.82	67.35
White 80	−13.27	43.06	57.36	64.93	67.70	70.47	70.60	74.84	78.32	79.40	67.40
White 85	−14.73	38.77	54.10	61.06	66.07	68.67	69.46	74.68	76.68	78.68	65.95
White 90	−19.68	36.96	53.10	61.65	66.87	68.13	70.18	71.97	75.04	77.40	65.59
White 95	−21.39	33.28	50.53	58.36	62.96	63.45	67.03	71.57	74.11	78.48	65.58
Nonwhite 45	13.72	54.41	72.40	68.73	74.74	69.83	76.80	78.40	83.03	74.74	68.36
Nonwhite 50	−3.94	53.60	64.67	67.12	71.95	73.68	76.33	75.26	75.66	77.54	66.59

TABLE 2.—LIFETIME SOCIAL SECURITY BENEFITS AS A SHARE OF LIFETIME SOCIAL SECURITY TAXES—Continued

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Nonwhite 55	2.24	54.60	65.80	66.33	73.71	75.64	79.03	84.84	82.59	75.41	67.33
Nonwhite 60	12.48	57.34	68.66	71.64	70.27	73.08	75.68	80.86	76.90	78.83	69.37
Nonwhite 65	17.81	56.51	59.55	69.42	69.39	75.43	76.06	74.64	69.28	79.53	67.77
Nonwhite 70	16.53	52.47	63.42	68.70	70.51	74.00	73.30	72.84	80.71	77.82	67.92
Nonwhite 75	−6.62	49.04	62.22	67.61	70.31	69.85	76.90	76.53	80.23	77.63	67.39
Nonwhite 80	7.10	49.41	59.86	66.52	67.65	71.05	70.30	77.05	75.84	79.61	67.82
Nonwhite 85	−0.90	50.00	60.94	65.70	65.86	69.32	71.10	72.17	79.03	76.89	66.48
Nonwhite 90	12.45	49.15	59.38	65.35	63.90	70.38	73.12	70.28	77.13	78.91	66.93
Nonwhite 95	−5.03	48.21	59.91	64.50	67.43	67.70	68.24	72.12	78.05	80.71	68.65
Noncollege 45	5.30	55.97	68.32	71.98	73.80	74.90	76.55	74.51	79.60	76.15	66.91
Noncollege 50	−23.05	48.72	62.25	68.82	71.36	74.19	75.64	77.49	78.61	76.68	63.79
Noncollege 55	−4.37	49.96	62.51	66.98	69.63	76.85	78.78	77.81	79.76	78.56	66.41
Noncollege 60	3.22	53.02	65.74	70.13	71.97	74.26	76.40	79.92	82.37	79.11	68.09
Noncollege 65	4.74	50.49	61.92	71.15	70.54	73.41	75.49	76.93	80.62	80.74	68.23
Noncollege 70	3.12	48.40	62.88	68.33	70.92	71.82	73.64	80.33	77.96	79.67	66.97
Noncollege 75	3.03	47.40	60.77	65.72	69.45	72.18	73.82	75.25	79.22	80.96	66.98
Noncollege 80	−4.33	46.66	59.38	64.92	69.60	69.13	71.49	74.45	78.55	80.10	66.45
Noncollege 85	−8.61	44.36	57.80	62.14	67.30	68.95	70.01	74.43	75.83	78.92	65.09
Noncollege 90	−4.56	41.00	54.62	63.23	66.67	69.00	72.59	73.48	75.26	77.34	64.69
Noncollege 95	−8.71	38.65	52.97	61.95	67.04	66.61	69.68	72.27	75.79	79.71	65.59
College 45	−1.56	45.80	63.13	67.65	73.51	76.61	77.35	76.38	74.40	78.18	68.76
College 50	−34.74	40.43	59.09	65.23	69.49	75.13	76.52	75.91	76.47	75.48	65.84
College 55	−23.64	44.81	62.43	67.86	71.66	73.11	76.22	78.26	76.07	77.50	68.00
College 60	−10.29	48.18	59.28	70.48	70.54	72.76	79.21	77.07	76.74	78.23	68.97
College 65	−6.10	49.09	60.19	67.88	71.57	72.32	73.57	72.93	78.32	79.67	69.16
College 70	−2.58	44.11	57.27	64.35	70.11	71.80	77.07	77.99	77.99	79.88	68.93
College 75	−14.28	41.74	59.05	67.17	67.13	68.45	73.37	73.93	78.73	78.35	67.73
College 80	−17.13	40.94	55.97	65.51	65.59	72.25	69.64	75.99	76.94	78.99	68.40
College 85	−17.89	36.44	52.20	61.43	64.75	68.65	69.55	74.25	78.31	78.05	66.92
College 90	−25.19	37.64	54.19	61.20	65.98	68.33	69.21	69.66	75.49	77.81	66.92
College 95	−34.41	34.60	52.25	57.44	60.78	61.76	64.89	71.16	73.66	78.32	66.74

TABLE 3.—AVERAGE LIFETIME OASI NET TAX RATES ASSUMING A 38-PERCENT TAX RATE INCREASE BEGINNING IN 1999

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Cohort 45	0.7	5.8	7.0	7.2	7.5	7.5	7.2	6.3	6.4	3.9	5.8
Cohort 50	−1.8	4.6	6.1	6.6	7.0	7.3	7.3	7.0	6.8	4.0	5.4
Cohort 55	−0.1	5.4	6.9	7.3	7.6	8.1	8.4	8.3	7.6	4.5	5.9
Cohort 60	1.1	6.3	7.8	8.4	8.5	8.8	9.1	8.8	9.0	4.6	6.3
Cohort 65	1.8	6.9	8.2	9.1	9.0	9.0	9.7	9.5	9.2	5.5	7.1
Cohort 70	2.4	7.3	9.0	9.3	9.9	9.9	10.6	10.6	10.2	5.7	7.5
Cohort 75	2.8	7.9	9.5	10.1	10.4	10.4	10.5	10.8	11.3	6.4	8.1
Cohort 80	2.9	8.3	9.7	10.5	10.6	11.0	10.8	11.4	11.2	6.8	8.4
Cohort 85	2.6	7.9	9.5	10.2	10.5	10.6	10.8	11.1	11.3	6.5	8.0
Cohort 90	2.6	7.9	9.3	10.2	10.5	10.6	10.8	10.5	11.4	7.1	8.4
Cohort 95	2.0	7.6	9.2	10.0	10.2	10.2	10.5	11.1	11.0	7.3	8.4
Men 45	5.2	6.6	7.5	7.6	7.9	7.7	7.3	6.5	7.1	4.2	6.3
Men 50	4.3	6.0	6.9	7.1	7.3	7.5	7.7	7.2	6.9	4.1	6.0
Men 55	5.0	7.0	7.5	8.0	8.0	8.5	8.8	9.0	8.0	4.6	6.4
Men 60	5.7	7.6	8.7	8.8	9.1	9.2	9.8	9.2	9.3	4.6	6.7
Men 65	6.3	8.2	9.1	9.6	9.5	9.3	10.0	9.6	9.4	5.7	7.5
Men 70	7.0	8.8	9.8	9.7	10.4	10.2	10.9	10.9	10.8	6.1	8.1
Men 75	7.3	9.3	10.1	10.7	10.6	11.1	11.1	11.5	11.6	6.6	8.6
Men 80	8.2	9.1	10.3	11.0	10.9	11.2	11.0	11.6	11.3	7.3	8.8
Men 85	7.2	8.8	10.3	10.7	10.7	10.6	11.3	11.6	12.0	6.6	8.3
Men 90	6.7	8.7	9.9	10.7	10.7	10.8	10.8	10.9	11.8	7.2	8.7

TABLE 3.—AVERAGE LIFETIME OASI NET TAX RATES ASSUMING A 38-PERCENT TAX RATE INCREASE BEGINNING IN 1999—Continued

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Men 95	5.7	8.5	9.7	10.0	10.6	10.2	10.7	11.4	11.0	7.4	8.6
Women 45	−0.3	5.2	6.3	6.3	6.6	6.5	6.9	5.6	4.5	2.9	4.8
Women 50	−3.8	3.7	5.2	5.8	6.3	7.0	6.3	6.3	6.6	3.7	4.3
Women 55	−2.2	4.4	6.2	6.4	6.9	7.3	7.6	7.3	6.7	4.3	5.1
Women 60	−0.9	5.3	6.8	7.7	7.7	8.2	7.9	8.3	8.2	4.5	5.7
Women 65	−0.2	5.9	7.3	8.5	8.2	8.5	9.2	9.3	8.7	4.9	6.4
Women 70	0.2	6.2	8.1	8.7	9.1	9.4	9.9	9.9	8.9	4.9	6.6
Women 75	0.7	6.9	8.8	9.3	10.0	9.4	9.7	10.0	10.4	6.0	7.4
Women 80	0.5	7.6	8.8	9.7	10.1	10.7	10.5	10.9	10.9	5.8	7.5
Women 85	0.8	7.2	8.9	9.6	10.2	10.6	10.0	10.3	9.7	6.2	7.7
Women 90	0.9	7.3	8.8	9.6	10.3	10.3	10.7	9.9	10.5	6.7	7.9
Women 95	0.6	7.0	8.6	9.9	9.7	10.2	10.2	10.5	11.1	7.0	8.0
White 45	0.6	5.8	6.9	7.3	7.5	7.5	7.3	6.2	6.3	3.9	5.7
White 50	−2.0	4.5	6.0	6.6	6.9	7.3	7.3	7.0	6.8	4.0	5.4
White 55	−0.2	5.3	6.8	7.3	7.5	8.1	8.4	8.3	7.5	4.4	5.9
White 60	0.9	6.2	7.7	8.4	8.5	8.7	9.2	8.8	9.1	4.6	6.3
White 65	1.5	6.8	8.2	9.1	8.9	9.0	9.6	9.5	9.4	5.4	7.0
White 70	2.1	7.2	8.8	9.3	9.9	9.9	10.5	10.7	10.2	5.8	7.5
White 75	2.8	7.8	9.4	10.1	10.3	10.3	10.4	10.8	11.3	6.3	8.0
White 80	2.5	8.1	9.7	10.5	10.6	10.9	10.7	11.5	11.0	6.7	8.2
White 85	2.3	7.7	9.4	10.1	10.5	10.7	10.7	11.2	11.1	6.4	7.9
White 90	1.8	7.6	9.2	10.2	10.7	10.6	10.7	10.9	11.4	7.1	8.3
White 95	1.7	7.2	9.0	9.9	10.0	10.0	10.4	11.0	11.0	7.2	8.2
Nonwhite 45	1.5	5.6	7.3	6.8	7.7	6.8	6.6	6.9	7.4	4.0	6.1
Nonwhite 50	0.0	5.3	6.5	6.6	7.6	7.6	7.0	7.2	6.9	4.4	5.9
Nonwhite 55	0.9	6.1	7.4	7.2	8.1	8.3	8.8	8.6	8.9	4.9	6.5
Nonwhite 60	2.5	7.0	8.4	8.3	8.9	9.0	7.8	9.6	8.3	4.1	6.2
Nonwhite 65	3.6	7.6	8.1	9.3	9.6	9.2	10.3	9.4	7.0	5.9	7.5
Nonwhite 70	4.0	8.1	9.5	9.2	9.8	10.1	10.6	10.2	10.1	5.4	7.5
Nonwhite 75	2.7	8.6	9.9	10.5	10.9	10.7	11.3	11.2	11.4	7.1	8.9
Nonwhite 80	4.7	9.0	9.7	10.5	10.5	11.3	11.2	10.9	11.8	8.1	9.4
Nonwhite 85	3.8	8.9	10.2	10.8	10.3	10.3	11.1	10.8	12.2	6.9	8.7
Nonwhite 90	5.2	9.0	9.9	10.1	9.9	10.6	11.0	9.4	11.4	7.0	8.6
Nonwhite 95	3.3	8.9	9.9	10.3	10.7	10.7	10.8	11.6	11.3	8.1	9.2
Noncollege 45	0.9	6.0	7.2	7.3	7.5	7.2	7.2	6.1	6.8	4.1	6.0
Noncollege 50	−1.5	4.9	6.3	6.8	7.1	7.4	7.2	7.1	6.7	4.4	5.7
Noncollege 55	0.5	5.6	6.9	7.3	7.5	8.4	8.7	8.3	8.0	4.8	6.2
Noncollege 60	1.6	6.6	8.0	8.2	8.5	9.0	9.1	9.2	9.3	5.0	6.8
Noncollege 65	2.2	7.1	8.4	9.3	9.0	9.2	9.8	9.9	9.5	5.8	7.5
Noncollege 70	2.7	7.6	9.2	9.6	9.9	10.0	10.3	10.8	10.1	6.2	7.9
Noncollege 75	3.5	8.2	9.6	9.9	10.5	10.7	10.5	11.2	11.5	6.8	8.5
Noncollege 80	3.4	8.6	9.8	10.2	10.7	10.8	10.6	11.5	11.7	7.4	8.8
Noncollege 85	3.0	8.3	9.7	10.2	10.6	10.6	10.8	11.3	11.1	6.8	8.4
Noncollege 90	3.3	8.1	9.3	10.3	10.8	10.7	10.8	10.5	11.7	7.8	8.9
Noncollege 95	3.0	7.8	9.2	10.1	10.4	10.7	10.9	11.6	10.9	8.2	9.0
College 45	0.1	5.0	6.4	6.8	7.4	7.8	7.3	6.5	5.9	3.8	5.4
College 50	−2.5	3.9	5.7	6.2	6.9	7.2	7.3	6.8	6.9	3.7	5.1
College 55	−1.4	5.1	6.8	7.3	7.7	7.8	8.1	8.2	7.1	4.2	5.5
College 60	0.0	5.9	7.4	8.6	8.5	8.5	9.0	8.4	8.5	4.2	5.8
College 65	1.0	6.7	8.0	8.8	8.9	8.7	9.5	8.8	8.7	5.2	6.6
College 70	2.0	7.0	8.6	9.0	9.9	9.8	10.8	10.5	10.3	5.4	7.1
College 75	1.5	7.6	9.3	10.4	10.3	10.1	10.6	10.4	11.1	6.1	7.8
College 80	2.1	7.9	9.5	10.9	10.4	11.2	11.0	11.4	10.8	6.5	8.0
College 85	2.0	7.4	9.3	10.2	10.3	10.6	10.8	11.0	11.5	6.3	7.8
College 90	1.3	7.7	9.3	10.0	10.2	10.6	10.8	10.6	11.1	6.6	7.9
College 95	0.3	7.3	9.1	9.8	9.9	9.6	10.1	10.8	11.2	6.8	7.8

TABLE 4.—AVERAGE LIFETIME OASI NET TAX RATES ASSUMING A 25-PERCENT REDUCTION IN SOCIAL SECURITY BENEFITS BEGINNING IN 1999

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Cohort 45	3.1	6.7	7.5	7.6	7.8	7.7	7.4	6.4	6.5	3.9	6.1
Cohort 50	0.4	5.3	6.4	6.8	7.1	7.3	7.1	6.8	6.6	3.9	5.6
Cohort 55	1.6	5.8	6.9	7.2	7.3	7.8	8.0	7.8	7.1	4.2	5.8
Cohort 60	2.4	6.3	7.4	7.7	7.9	8.0	8.1	8.0	8.0	4.1	5.8
Cohort 65	2.7	6.4	7.3	7.9	7.7	7.7	8.2	8.1	7.8	4.6	6.2
Cohort 70	2.6	6.2	7.3	7.5	7.9	7.9	8.4	8.3	8.0	4.6	6.0
Cohort 75	2.3	6.0	7.1	7.6	7.8	7.7	7.8	8.1	8.4	4.8	6.1
Cohort 80	1.9	5.9	6.9	7.6	7.6	7.9	7.8	8.2	8.1	4.9	6.0
Cohort 85	1.6	5.6	6.8	7.3	7.5	7.6	7.8	8.0	8.2	4.7	5.8
Cohort 90	1.6	5.6	6.7	7.3	7.6	7.6	7.8	7.6	8.2	5.1	6.0
Cohort 95	1.2	5.4	6.6	7.2	7.3	7.3	7.5	8.0	7.9	5.3	6.0
Men 45	6.2	7.2	7.9	7.9	8.1	7.9	7.4	6.6	7.1	4.2	6.4
Men 50	4.9	6.3	7.1	7.1	7.3	7.4	7.5	7.0	6.7	4.0	6.0
Men 55	5.4	6.9	7.3	7.6	7.6	8.1	8.2	8.4	7.5	4.3	6.1
Men 60	5.7	7.2	8.0	8.0	8.3	8.2	8.7	8.2	8.2	4.1	6.0
Men 65	5.9	7.2	7.8	8.2	8.0	7.9	8.4	8.1	7.9	4.8	6.4
Men 70	5.8	7.1	7.8	7.7	8.2	8.0	8.6	8.5	8.5	4.9	6.4
Men 75	5.5	6.9	7.6	7.9	7.9	8.2	8.2	8.6	8.6	4.9	6.4
Men 80	5.8	6.5	7.4	8.0	7.9	8.1	7.9	8.4	8.2	5.3	6.4
Men 85	5.1	6.3	7.4	7.7	7.7	7.6	8.1	8.4	8.7	4.7	6.0
Men 90	4.7	6.2	7.1	7.7	7.7	7.8	7.8	7.9	8.5	5.2	6.2
Men 95	3.9	6.0	7.0	7.2	7.6	7.3	7.7	8.2	7.9	5.4	6.2
Women 45	2.4	6.3	7.0	6.8	6.9	6.8	7.1	5.8	4.6	3.0	5.5
Women 50	−1.1	4.6	5.8	6.2	6.5	7.1	6.2	6.3	6.6	3.6	4.8
Women 55	0.1	5.1	6.4	6.5	6.9	7.1	7.4	6.9	6.3	4.0	5.2
Women 60	1.0	5.7	6.8	7.3	7.3	7.6	7.2	7.6	7.5	4.0	5.5
Women 65	1.3	5.8	6.8	7.6	7.3	7.5	8.0	8.1	7.5	4.2	5.8
Women 70	1.0	5.5	6.8	7.3	7.5	7.6	8.0	7.9	7.1	4.0	5.5
Women 75	0.9	5.3	6.7	7.1	7.5	7.0	7.3	7.5	7.8	4.5	5.6
Women 80	0.1	5.4	6.3	7.0	7.3	7.7	7.6	7.9	7.9	4.2	5.4
Women 85	0.2	5.1	6.4	6.9	7.3	7.6	7.2	7.4	7.0	4.5	5.5
Women 90	0.4	5.2	6.2	6.9	7.4	7.4	7.7	7.1	7.6	4.8	5.6
Women 95	0.1	4.9	6.1	7.1	7.0	7.3	7.3	7.6	8.0	5.1	5.7
White 45	3.1	6.7	7.5	7.6	7.8	7.7	7.4	6.3	6.4	3.9	6.1
White 50	0.3	5.2	6.4	6.8	7.0	7.2	7.2	6.8	6.6	3.9	5.5
White 55	1.5	5.7	6.8	7.2	7.3	7.8	7.9	7.8	7.0	4.2	5.7
White 60	2.2	6.3	7.3	7.7	7.8	8.0	8.3	7.9	8.1	4.2	5.9
White 65	2.4	6.3	7.3	7.9	7.7	7.7	8.2	8.1	8.0	4.6	6.1
White 70	2.4	6.1	7.2	7.5	7.9	7.9	8.3	8.4	8.0	4.6	6.0
White 75	2.3	5.9	7.1	7.5	7.7	7.7	7.7	8.0	8.3	4.7	6.0
White 80	1.6	5.8	6.9	7.6	7.6	7.9	7.7	8.3	8.0	4.8	5.9
White 85	1.4	5.4	6.7	7.3	7.6	7.7	7.7	8.0	8.0	4.6	5.7
White 90	1.0	5.4	6.6	7.3	7.7	7.6	7.7	7.8	8.2	5.1	6.0
White 95	0.9	5.0	6.4	7.1	7.2	7.2	7.5	7.9	7.9	5.2	5.9
Nonwhite 45	3.5	6.5	7.7	7.2	8.0	7.1	6.6	7.0	7.4	4.1	6.5
Nonwhite 50	1.7	5.9	6.7	6.7	7.6	7.6	6.9	7.0	6.8	4.3	6.1
Nonwhite 55	2.3	6.4	7.3	7.0	7.8	7.8	8.2	7.9	8.3	4.6	6.3
Nonwhite 60	3.5	6.9	7.9	7.7	8.2	8.2	7.0	8.6	7.4	3.7	5.7
Nonwhite 65	3.9	6.8	7.2	8.0	8.2	7.9	8.7	8.0	5.9	5.1	6.5
Nonwhite 70	3.8	6.6	7.6	7.5	7.8	8.1	8.5	8.1	7.9	4.3	6.1
Nonwhite 75	2.1	6.5	7.5	7.8	8.1	8.0	8.4	8.3	8.5	5.3	6.6
Nonwhite 80	3.2	6.4	7.0	7.6	7.6	8.1	8.0	7.9	8.5	5.9	6.7
Nonwhite 85	2.5	6.3	7.3	7.7	7.4	7.4	8.0	7.7	8.8	5.0	6.2
Nonwhite 90	3.6	6.4	7.1	7.3	7.1	7.6	7.9	6.8	8.2	5.0	6.2
Nonwhite 95	2.2	6.3	7.1	7.4	7.7	7.7	7.8	8.4	8.2	5.8	6.6
Noncollege 45	3.2	6.9	7.7	7.7	7.8	7.4	7.3	6.2	6.8	4.1	6.4
Noncollege 50	0.6	5.6	6.6	7.0	7.1	7.4	7.1	7.0	6.5	4.3	5.9
Noncollege 55	2.0	5.9	6.9	7.2	7.3	8.0	8.1	7.8	7.4	4.5	6.1
Noncollege 60	2.7	6.5	7.5	7.6	7.9	8.1	8.2	8.3	8.3	4.5	6.3
Noncollege 65	2.9	6.5	7.4	8.1	7.8	7.9	8.3	8.4	8.1	4.9	6.5
Noncollege 70	2.8	6.3	7.5	7.7	8.0	8.0	8.2	8.5	8.0	5.0	6.4

TABLE 4.—AVERAGE LIFETIME OASI NET TAX RATES ASSUMING A 25-PERCENT REDUCTION IN SOCIAL SECURITY BENEFITS BEGINNING IN 1999—Continued

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Noncollege 75	2.8	6.2	7.2	7.4	7.8	8.0	7.8	8.4	8.5	5.1	6.4
Noncollege 80	2.3	6.1	7.1	7.3	7.8	7.8	7.6	8.3	8.4	5.3	6.4
Noncollege 85	1.9	5.9	7.0	7.3	7.6	7.7	7.8	8.1	8.0	4.9	6.0
Noncollege 90	2.2	5.7	6.7	7.4	7.8	7.7	7.8	7.6	8.4	5.6	6.4
Noncollege 95	1.9	5.5	6.6	7.2	7.5	7.7	7.8	8.3	7.8	5.9	6.5
College 45	2.8	6.1	7.0	7.3	7.7	8.0	7.4	6.6	6.0	3.8	5.7
College 50	−0.1	4.8	6.1	6.4	7.0	7.1	7.2	6.7	6.8	3.6	5.2
College 55	0.7	5.5	6.9	7.2	7.4	7.5	7.7	7.8	6.7	3.9	5.4
College 60	1.7	6.0	7.1	8.0	7.9	7.8	8.1	7.5	7.6	3.8	5.3
College 65	2.1	6.4	7.2	7.8	7.7	7.5	8.1	7.5	7.3	4.4	5.8
College 70	2.4	6.0	7.0	7.3	7.9	7.8	8.5	8.2	8.1	4.3	5.7
College 75	1.4	5.8	7.1	7.8	7.7	7.5	7.9	7.8	8.2	4.6	5.8
College 80	1.3	5.6	6.8	7.8	7.5	8.1	7.9	8.2	7.8	4.7	5.7
College 85	1.2	5.2	6.6	7.3	7.4	7.6	7.7	7.9	8.3	4.5	5.6
College 90	0.6	5.4	6.6	7.2	7.3	7.6	7.7	7.6	8.0	4.8	5.7
College 95	−0.1	5.1	6.5	7.1	7.1	6.9	7.2	7.8	8.1	4.9	5.6

TABLE 5.—OASI INTERNAL RATES OF RETURN

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
Cohort 45	4.91	3.00	1.99	1.53	1.21	0.88	0.78	0.92	0.52	0.53	1.84
Cohort 50	5.63	3.27	2.27	1.73	1.46	0.97	0.79	0.54	0.56	0.70	1.98
Cohort 55	5.25	3.17	2.21	1.81	1.49	0.93	0.62	0.52	0.47	0.54	1.81
Cohort 60	5.03	3.03	2.19	1.54	1.47	1.19	0.63	0.46	0.29	0.57	1.73
Cohort 65	4.97	3.10	2.38	1.64	1.53	1.27	1.07	0.97	0.34	0.39	1.74
Cohort 70	4.98	3.29	2.44	1.92	1.57	1.40	1.06	0.40	0.57	0.43	1.80
Cohort 75	5.09	3.38	2.48	1.95	1.73	1.61	1.20	1.12	0.47	0.52	1.87
Cohort 80	5.24	3.42	2.61	2.09	1.79	1.53	1.56	0.97	0.52	0.52	1.85
Cohort 85	5.31	3.57	2.79	2.36	2.00	1.70	1.65	1.14	0.75	0.66	1.99
Cohort 90	5.31	3.63	2.83	2.29	1.94	1.68	1.47	1.42	0.96	0.69	1.97
Cohort 95	5.45	3.73	2.89	2.39	2.10	2.03	1.78	1.33	0.93	0.41	1.87
Men 45	3.35	2.07	1.29	1.11	0.92	0.62	0.55	0.65	0.07	0.26	0.88
Men 50	3.45	2.27	1.55	1.21	1.08	0.64	0.35	0.21	0.27	0.48	0.99
Men 55	3.40	2.19	1.60	1.20	1.13	0.49	0.11	−0.01	0.17	0.35	0.91
Men 60	3.36	2.09	1.45	1.04	1.00	0.83	−0.09	−0.13	0.00	0.38	0.85
Men 65	3.41	2.26	1.62	1.14	0.92	0.83	0.89	0.74	0.09	0.11	0.90
Men 70	3.35	2.46	1.72	1.43	1.10	1.13	0.72	0.22	0.31	0.17	0.99
Men 75	3.50	2.64	1.85	1.50	1.40	1.07	0.68	0.51	0.06	0.27	1.07
Men 80	3.47	2.74	2.06	1.53	1.42	1.06	1.34	0.73	0.35	0.25	1.09
Men 85	3.82	2.96	2.17	1.88	1.63	1.47	1.10	0.74	0.17	0.47	1.25
Men 90	4.08	3.12	2.21	1.77	1.74	1.38	1.41	1.12	0.70	0.48	1.32
Men 95	4.37	3.23	2.44	2.16	1.62	1.87	1.54	1.20	0.81	0.25	1.29
Women 45	5.11	3.42	2.63	2.24	1.84	1.80	1.47	1.63	1.81	1.52	3.06
Women 50	6.06	3.77	2.89	2.45	2.15	1.61	1.65	1.41	1.16	1.31	3.15
Women 55	5.73	3.69	2.77	2.50	2.00	1.73	1.50	1.21	1.09	0.99	2.82
Women 60	5.47	3.57	2.80	2.12	2.04	1.63	1.50	1.15	0.97	0.96	2.65
Women 65	5.42	3.59	2.99	2.19	2.21	1.90	1.37	1.27	0.90	1.03	2.67
Women 70	5.48	3.77	2.97	2.48	2.17	1.83	1.57	0.79	1.14	0.95	2.71
Women 75	5.51	3.82	2.95	2.49	2.24	2.28	1.85	1.74	1.26	1.02	2.75
Women 80	5.72	3.82	3.15	2.70	2.23	2.02	1.83	1.46	0.87	1.11	2.75
Women 85	5.69	3.94	3.19	2.82	2.41	2.03	2.32	1.73	1.76	1.05	2.80
Women 90	5.65	3.92	3.29	2.76	2.20	2.01	1.59	1.88	1.47	1.10	2.72
Women 95	5.74	4.02	3.27	2.64	2.59	2.28	2.09	1.65	1.11	0.76	2.59
White 45	4.94	3.02	2.06	1.51	1.24	0.81	0.78	0.97	0.63	0.48	1.84
White 50	5.69	3.33	2.33	1.71	1.46	0.93	0.77	0.52	0.52	0.72	2.00
White 55	5.29	3.22	2.25	1.79	1.55	0.93	0.62	0.62	0.50	0.50	1.82
White 60	5.08	3.09	2.26	1.56	1.45	1.19	0.58	0.49	0.24	0.56	1.74

TABLE 5.—OASI INTERNAL RATES OF RETURN—Continued

[Lifetime Labor Earnings in 1997 Dollars]

	0–120k	120k–240k	240k–360k	360k–480k	480k–600k	600k–720k	720k–840k	840k–960k	960k–1.08m	1.08m+	Total
White 65	5.05	3.18	2.34	1.65	1.51	1.30	1.10	0.93	0.17	0.37	1.73
White 70	5.06	3.36	2.50	1.95	1.56	1.42	1.01	0.26	0.65	0.37	1.80
White 75	5.07	3.43	2.50	1.98	1.78	1.61	1.25	1.19	0.51	0.47	1.87
White 80	5.33	3.47	2.64	2.10	1.80	1.56	1.54	1.03	0.44	0.53	1.86
White 85	5.37	3.68	2.88	2.42	2.01	1.72	1.67	1.09	0.79	0.62	2.00
White 90	5.47	3.75	2.92	2.34	1.90	1.72	1.51	1.39	0.99	0.72	1.99
White 95	5.52	3.89	3.02	2.48	2.17	2.10	1.77	1.33	1.01	0.47	1.92
Nonwhite 45	4.64	2.91	1.47	1.69	0.93	1.60	0.67	0.48	−0.36	1.11	1.78
Nonwhite 50	5.11	2.88	1.91	1.82	1.44	1.27	0.90	0.69	0.80	0.51	1.83
Nonwhite 55	4.94	2.81	1.96	1.88	1.05	0.89	0.61	−0.90	0.05	0.91	1.78
Nonwhite 60	4.62	2.69	1.72	1.42	1.59	1.15	1.01	0.18	0.73	0.64	1.65
Nonwhite 65	4.43	2.69	2.55	1.61	1.66	1.07	0.85	1.18	1.61	0.51	1.81
Nonwhite 70	4.52	2.98	2.20	1.76	1.61	1.30	1.28	1.27	0.05	0.75	1.83
Nonwhite 75	5.17	3.18	2.37	1.80	1.53	1.65	0.91	0.69	0.33	0.76	1.86
Nonwhite 80	4.81	3.15	2.48	2.05	1.74	1.37	1.61	0.67	0.76	0.43	1.81
Nonwhite 85	5.02	3.08	2.38	2.07	1.96	1.61	1.54	1.44	0.51	0.86	1.94
Nonwhite 90	4.65	3.15	2.47	2.03	2.13	1.53	1.28	1.51	0.78	0.53	1.88
Nonwhite 95	5.13	3.20	2.41	2.00	1.86	1.71	1.81	1.32	0.45	0.16	1.67
Noncollege 45	4.86	2.83	1.85	1.39	1.15	0.97	0.77	1.01	0.19	0.61	1.89
Noncollege 50	5.57	3.12	2.18	1.59	1.38	1.04	0.78	0.46	0.33	0.62	2.04
Noncollege 55	5.12	3.06	2.20	1.83	1.55	0.66	0.37	0.50	0.25	0.47	1.85
Noncollege 60	4.91	2.90	1.97	1.53	1.39	1.00	0.77	0.28	−0.09	0.47	1.73
Noncollege 65	4.87	3.02	2.27	1.44	1.56	1.19	0.98	0.79	0.12	0.29	1.74
Noncollege 70	4.91	3.17	2.23	1.68	1.54	1.41	1.25	0.14	0.56	0.47	1.87
Noncollege 75	4.92	3.23	2.36	1.97	1.61	1.33	1.14	0.96	0.48	0.21	1.86
Noncollege 80	5.11	3.28	2.47	2.08	1.56	1.69	1.43	1.12	0.41	0.39	1.92
Noncollege 85	5.22	3.39	2.60	2.30	1.86	1.65	1.58	1.11	0.94	0.59	2.04
Noncollege 90	5.12	3.55	2.78	2.20	1.86	1.64	1.27	1.25	0.98	0.70	2.05
Noncollege 95	5.23	3.65	2.84	2.20	1.83	1.86	1.56	1.22	0.76	0.30	1.92
College 45	5.04	3.44	2.36	1.81	1.33	0.79	0.78	0.81	0.97	0.46	1.75
College 50	5.78	3.60	2.45	1.99	1.57	0.83	0.80	0.63	0.78	0.77	1.88
College 55	5.55	3.38	2.25	1.77	1.37	1.24	0.95	0.55	0.78	0.61	1.75
College 60	5.25	3.24	2.57	1.57	1.57	1.40	0.34	0.69	0.73	0.65	1.72
College 65	5.16	3.22	2.54	1.90	1.50	1.38	1.19	1.27	0.62	0.47	1.73
College 70	5.07	3.46	2.70	2.18	1.61	1.40	0.87	0.59	0.57	0.39	1.74
College 75	5.34	3.57	2.61	1.92	1.87	1.81	1.24	1.26	0.46	0.73	1.88
College 80	5.40	3.59	2.76	2.09	2.01	1.32	1.67	0.82	0.62	0.60	1.79
College 85	5.43	3.79	3.02	2.44	2.13	1.74	1.69	1.17	0.55	0.71	1.93
College 90	5.58	3.74	2.90	2.38	2.04	1.72	1.62	1.59	0.94	0.68	1.89
College 95	5.77	3.85	2.95	2.56	2.36	2.21	1.98	1.41	1.10	0.49	1.83

TABLE 6.—INTERNATIONAL COMPARISONS OF GENERATIONAL ACCOUNTING ALTERNATIVE WAYS TO ACHIEVE GENERATIONAL BALANCE

Country	Cut in government purchases		Cut in government transfers		Increase in all taxes		Increase in income tax	
	A	B	A	B	A	B	A	B
Argentina	24.6	29.1	16.8	11.0	10.7	8.4	97.1	75.7
Australia	8.8	10.2	12.1	9.1	5.1	4.8	8.5	8.1
Austria	56.8	76.4	25.0	20.5	20.1	18.4	60.7	55.6
Belgium	11.2	12.4	6.0	4.6	3.7	3.1	11.7	10.0
Brazil	23.8	26.2	21.3	17.9	12.4	11.7	78.9	74.0
Canada	0.0	0.1	0.0	0.1	0.0	0.1	0.0	0.2
Denmark	9.9	29.0	4.7	4.5	3.4	4.0	5.8	6.7
Finland	47.6	67.6	26.5	21.2	20.6	19.4	54.1	50.8
Germany	21.1	25.9	17.6	14.1	9.5	9.5	29.5	29.5
Ireland	−2.1	−4.3	−2.5	−4.4	−1.1	−2.1	−2.5	−4.8
Italy	37.0	49.1	18.0	13.3	12.4	10.5	33.3	28.2
Japan	26.0	29.5	28.6	25.3	15.5	15.5	53.6	53.6
Netherlands	21.0	28.7	21.4	22.3	8.5	8.9	14.9	15.6
New Zealand	−1.0	−1.6	−0.8	−0.6	−0.4	−0.4	−0.8	−0.8

TABLE 6.—INTERNATIONAL COMPARISONS OF GENERATIONAL ACCOUNTING ALTERNATIVE WAYS TO ACHIEVE GENERATIONAL BALANCE—Continued

Country	Cut in government purchases		Cut in government transfers		Increase in all taxes		Increase in income tax	
	A	B	A	B	A	B	A	B
Norway	11.5	9.9	9.4	8.1	7.4	6.3	11.3	9.7
Portugal	7.6	9.8	9.6	7.5	4.2	4.2	13.3	13.3
Spain	50.6	62.2	22.5	17.0	17.4	14.5	53.9	44.9
Sweden	37.6	50.5	22.6	18.9	16.1	15.6	42.9	41.9
Thailand	−38.1	−47.7	−185.1	−114.2	−25.0	−25.0	−81.7	−81.8
France	17.2	22.2	11.5	9.8	7.1	6.9	66.0	64.0
United Kingdom	6.6	9.7	9.6	9.5	2.6	2.7	9.4	9.5
United States	18.7	27.0	19.8	20.3	10.5	10.8	23.8	24.4

A. Education expenditure treated as government consumption.
B. Education expenditure treated as government transfers and distributed by age groups.
Sources: Kotlikoff and Leibfritz (1999) and Raffelheuschen (1998) and authors' calculations.

Chairman SMITH. Ms. Olsen.

STATEMENT OF DARCY OLSEN, ENTITLEMENTS ANALYST, CATO INSTITUTE

Ms. OLSEN. Mr. Chairman, members of the committee and colleagues, thank you for the opportunity to come here today to talk to you about Social Security's impact on different groups with a particular emphasis on women.

I love the title of this hearing, and I loved it from the minute that Sue said it to me. The title of it is How Uniformity Deals with Diversity: Does One Size Fit All? When she told me that, I immediately got this picture of my little sister, who is 10 years old, she is about this high, she is about 60 pounds, and I have this picture of her putting on my older brother's suit coat, and my older brother—it is funny because he is 6-foot-6 and he weighs about 180 pounds. So I can tell you how uniformity deals with diversity when it comes to clothing.

Now, on a serious note, in a very important sense, the current Social Security system does treat everyone in the same uniform manner, because it gives every worker, no matter what their income, their ancestry or their gender, an inexcusably meager return on a lifetime of payroll tax contributions. And that is, I think, one of the most important things to keep in mind as you try to determine what this Nation's future retirement system should look like. Substandard returns, whether they are shared equally or unequally, are not something to boast about.

That said, I have spent a great deal of time studying the impact of Social Security on women, and the bottom line is that while Social Security is, on its face, neutral, its impact on men and women is very different. First of all, because women generally work fewer years and earn less than men do, their benefits are lower. So the average woman's benefit is about $600 per month compared to about $800 per month for a man. The result of those lower benefits is higher poverty rates, so you have poverty rates among women that are twice as high as they are among men, 14 percent versus about 6 percent.

Another problem with the way the system treats women is that 25 percent of working women, one in four of us, pay into this system and don't get a dime back in benefits based on all the years of payroll contributions that we have paid. Now, this is the result of something called the "dual entitlement rule," and you have to bear with me to explain this. It says, a woman can collect benefits based on—as being a worker in her own right or as the spouse of another worker, but she can't collect both benefits. She only gets the higher of the two.

Now, for 25 percent of women, their benefits as spouses are higher than the benefits that they earned in their own right. So while a woman may end up with a larger benefit than she earned in her own right, she still has paid payroll taxes for which she gets nothing in direct return. Let me give you an illustration.

What it means is this: You can have a wife who has never entered the paid labor force or paid a dime in payroll taxes and she will be collecting the same exact benefit as a single woman who has spent 40 years paying payroll taxes to the Social Security system.

Now, supporters of this rule think this is OK, because these women end up with larger benefits than they would have otherwise based on their own work records. But the truth is that if Congress would let women take their payroll taxes and deposit them into personal retirement accounts, women wouldn't need that preference, they wouldn't need that favoritism. Instead, every single dollar they earned would work toward their retirements and improve their retirement security.

Now, what I have attached to my testimony is a study that we have done at the Cato Institute, which shows how much better off women would be under this kind of system of personally owned retirement accounts. We studied a cohort of women who actually retired in 1981 using Social Security data, and found that not one of these women would have been worse off under the private system and virtually all of them would have been—almost all of them would have been significantly better off under the private system, and that is based on actual market returns.

And we also did a perspective analysis and found that the majority of women in our country would gain an additional $800 or more per month if they were allowed to go to this private system. That is more than doubling what Social Security is now promising to pay, but doesn't really have the money to make good on.

So, as you know, Social Security has been written, the rules have been structured in a way that tries to minimize any inequality of outcomes through the progressive benefit structure, but there are significant differences that remain in outcomes. I will give you another example. You can look at different groups of men and consider the African-American man compared to the Caucasian male. Upon reaching age 65, the average African-American male can expect to live 2 years less, die 2 years earlier than the average Caucasian male, which means that the average Caucasian male in this sense wins out, and he is the winner because he collects 2 more years from Social Security than the average African-American man.

But this is the point: If we focus only on those technical defects, things like that, things like the dual entitlement rule, we would be missing the big picture, which is that no matter what group you are in, Social Security is not a very good deal. Most workers born around 1960, regardless of their gender, their marital status, their ancestry or their incomes, can expect rates of return on their payroll tax contributions between 1 and 2 percent.

So while Caucasian men may fare better than African-American men and some people would say that men fare better under this system than women, no group fares well. So the most important thing for the Task Force to consider, I think, is that a redesigned system that is based on individually owned accounts can significantly increase the retirement incomes of every worker, no matter what their retirement income—excuse me, no matter what their income, their ancestry or their gender might be, and that is how a system of personal accounts will deal with diversity.

Chairman SMITH. Thank you.

[The prepared statement of Ms. Olsen follows:]

PREPARED STATEMENT OF DARCY ANN OLSEN, ENTITLEMENTS ANALYST, CATO INSTITUTE

Mr. Chairman, distinguished members of the committee, colleagues: Thank you for the opportunity to appear before this committee to discuss Social Security and its impact on varying types of workers, particularly women.

In one fairly important sense, the current Social Security system treats everyone equally because it gives every worker—no matter what their income, their ancestry, their gender—an inexcusably low return on a lifetime of payroll tax contributions. That is one of the most important things to remember when you decide what the nation's future retirement system should look like. Substandard returns, whether shared equally or unequally across different populations, are not something to be proud of.

That said, I have spent a good deal of time studying the impact of the current system on women. The bottom line is that while Social Security does not differentiate between women and men, yet its impact on men and women is quite different.

Because women generally work fewer years and earn less than men do, women receive lower benefits from Social Security than do men: the average woman's benefit is little more than $600 per month, the average man's benefit is more than $800.

The result of those lower benefits is higher poverty rates. Poverty rates are twice as high among elderly women as among elderly men: 14 percent compared to 6 percent.

According to the Social Security Administration, 25 percent of women pay into the Social Security system and get back nothing in return. (This happens to less than 1 percent of men.) That is the result of the dual entitlement rule, which says a woman can collect benefits based on her own work record or based on her status as a spouse, but she cannot collect both. She can collect only the larger of the two. For 25 percent of women, their benefits as spouses are larger than their benefits as workers. Therefore, while a woman might receive a larger check as a spouse than she would have based on her own work record, she has still paid payroll taxes during her working years for which she gets nothing. This means that a wife who never enters the workforce or pays a dime in Social Security taxes can, under Social Security, collect the same monthly benefit as a single woman who spent her entire adult life in the workforce.

Supporters of the dual entitlement rule believe this treatment of women is acceptable because women end up with larger benefits than they would have based on their own work records. If the world were static, I might agree with that argument. But it isn't. The truth is that if Congress would allow women to deposit their payroll taxes into personal retirement accounts, every dollar they earned would work for them by increasing their retirement incomes. Couples could also choose to share their earnings, which would further increase their retirement funds. I've attached a study we published at the Cato Institute called "Greater Benefits for Women with Personal Retirement Accounts," which shows just how much better off women would be if they were allowed to enter a new system of individually owned retirement accounts.

Consider the most difficult scenario: a single woman earning $12,000 a year, roughly the minimum wage. She pays $1,488 per year in Social Security taxes. When she retires, Social Security promises her $683 per month (assuming solvency). If she were allowed instead to save and invest her money in a portfolio of stocks and bonds earning a 6.2 percent return, she would retire with $936 per month.

Those conservatively estimated benefits are roughly 30 percent greater than what she could expect from Social Security.

Despite the fact that Social Security's rules have been rewritten over the years to try to minimize inequality of outcomes, significant differences and treatment continue to exist, especially for women. But if we focus on those technical defects, we'd be missing the big picture, which is that Social Security isn't a very good deal for any worker.

Most workers born around 1960, regardless of gender, marital status, ancestry, or income, can expect rates of return on their payroll tax contributions between 1 and 2 percent.

Today's average 20-year-old male can expect to pay $182,000 more in Social Security taxes than he will receive in benefits.

So while men may be "better off" than women under Social Security, neither group fares well.

The most important thing for this task force to consider is that a redesigned system based on individually owned accounts can significantly increase the retirement incomes of all workers, no matter what their income, their ancestry, or their gender. That is how a system of personal retirement accounts will deal with diversity.

CATO BRIEFING PAPER NO. 38, JULY 20, 1998: GREATER FINANCIAL SECURITY FOR WOMEN WITH PERSONAL RETIREMENT ACCOUNTS

BY DARCY ANN OLSEN

INTRODUCTION

Plans to privatize Social Security—that is, to redirect payroll tax payments into personal accounts similar to individual retirement accounts or 401(k) plans—have become enormously popular. Polls show that a large majority of Americans favor some amount of privatization. Democratic and Republican legislators have introduced bills that would privatize the system to varying degrees. And experts of various ideological persuasions have endorsed privatization. Yet many questions about privatization remain, particularly with regard to women. Would poor women be able to weather market downturns? Would they be capable investors? What about women's aversion to risk?

Many people agree that a retirement system should address poverty among the elderly. That, after all, was the primary reason for establishing Social Security. Unfortunately, the current Social Security system does not adequately address poverty among the elderly, particularly elderly women. Although the current Social Security system does not differentiate between men and women, on average, women receive lower benefits than do men. That is primarily because women tend to have lower wages and fewer years in the workforce. Thus, poverty rates are twice as high among elderly women as among elderly men: 13.6 percent compared to 6.2 percent. Although Social Security alleviates some poverty, clearly there is room for improvement.

In contrast, research shows that virtually every woman—single, divorced, married, or widowed—would probably be better off financially under a system of fully private, personal retirement accounts, the earnings of which could be shared by spouses. And the greater the contribution rate, the greater the financial security. Thus, a fully private system with a 10 percent contribution rate would benefit women more than a partly private two-tiered system. That is true even for poor women who move in and out of the job market.

INEQUITY IN THE PRESENT SYSTEM

By law, the Social Security system treats all workers equally. Yet the system has a disparate impact on women because they typically earn less, work fewer years, and live longer than do men. In particular, Social Security punishes married women who work and favors married women who do not work. A married women who works her entire adult life may not receive any more benefits than a married woman who has never worked; a couple with two breadwinners may get fewer benefits than a couple with one breadwinner and identical lifetime earnings, and widows of two-earner couples may get less than widows of one-earner couples.

Those inequities result from the way benefits are calculated. A spouse can receive benefits in one of three ways. First, she can receive benefits based on her own work history. Second, she can receive benefits based on her husband's work history. By law, a woman is automatically entitled to benefits equal to 50 percent of her husband's benefits, whether or not she has ever worked or paid Social Security taxes. Third, she can receive benefits based on a combination of the two.

When a woman qualifies for benefits both as a worker in her own right and as a spouse (or surviving spouse) of a worker, she is subject to the "dual entitlement rule." That rule prevents her from collecting both her own retirement benefit and her spousal benefit. Instead, she receives only the larger of the two. And because the typical woman earns less and works fewer years than her husband, 50 percent of her husband's benefits is often larger than the benefits she would be entitled to receive in her own right. Consequently, she receives benefits based on only her husband's earnings—she receives no credit or benefits based on the payroll taxes she has paid. A woman who never worked at all receives exactly the same benefits.

The second inequity that results under Social Security's dual-entitlement rule is that a couple with two breadwinners may get fewer benefits than a couple with one breadwinner and identical lifetime earnings. Table 1 illustrates this point.

TABLE 1.—COUPLES BENEFITS UNDER DUAL ENTITLEMENT

	Monthly earnings ($)	Monthly benefit ($)
Couple A:		
Husband	1,000	573
Wife (no income)	0	287
Total	1,000	860
Couple B:		
Husband	500	413
Wife	500	413
Total	1,000	826
Couple C:		
Husband	667	467
Wife	333	300
Total	1,000	767

Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 4.

Note: Monthly Earnings is the Average Indexed Monthly Earnings (AIME), which is found by adding the 35 years of a worker's highest indexed earnings and dividing by 420 (the number of months in 35 years). In this example, it is assumed that the workers' combined earnings equaled $1,000. The Monthly Benefit is the Primary Insurance Amount (PIA). The following progressive benefit formula is applied to the AIME to determine the PIA (1996): 90% of the first $437 of AIME, 32% of AIME from $437 to $2,635, and 15% of AIME over $2,635.

Each of the three couples has the same total earnings, yet couple A with one breadwinner receives higher benefits than do couples B and C with two breadwinners. During 1 year, couple A will receive $1,116 more than couple C. After 10 years, couple A will have received more than $11,000 more in retirement benefits than couple C. As men and women who reach age 65 are expected to live to age 80 or beyond, that inequity can have a significant impact on a couple's quality of life for many years.

While the dual-entitlement rule has a negative impact on many two-earner couples during their retirement years together, its most pernicious impact is often felt after a husband dies. Social Security's survivor benefit rules can leave widows with up to 50 percent less income than the couple was receiving when the husband was alive. That is one reason why the poverty rate among widows is 19.2 percent, two times greater than among widowers. And, in general, the more of the couple's earnings the widow earned, the smaller the share of the couple's retirement benefit she receives after her husband dies. Table 2 illustrates this point.

TABLE 2.—WIDOWS' BENEFITS UNDER DUAL ENTITLEMENT

	Monthly Earnings ($)	Couple's Benefit ($)	Widow's Benefit ($)
Couple A:			
Husband	1,000		
Wife (no income)	0	860	573
Total	1,000		
Couple B:			
Husband	500		
Wife	500	826	413
Total	1,000		
Couple C:			
Husband	667		
Wife	333	767	467

TABLE 2.—WIDOWS' BENEFITS UNDER DUAL ENTITLEMENT—Continued

	Monthly Earnings ($)	Couple's Benefit ($)	Widow's Benefit ($)
Total	1,000		

Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 5.
Note: Monthly Earnings is the Average Indexed Monthly Earnings (AIME), which is found by adding the 35 years of a worker's highest indexed earnings and dividing by 420 (the number of months in 35 years). In this example, it is assumed that the workers' combined earnings equaled $1,000. The Monthly Benefit is the Primary Insurance Amount (PIA). The following progressive benefit formula is applied to the AIME to determine the PIA (1996): 90% of the first $437 of AIME, 32% of AIME from $437 to $2,635, and 15% of AIME over $2,635.

Each of the three couples has the same total earnings, yet the widow who never worked (A) receives higher benefits than the widows who worked (B and C). Widow A's benefits are approximately 16 percent higher than widow B's and 10 percent higher than widow C's. As Tables 1 and 2 indicate, the one-earner couple (couple A) receives the highest retirement benefits while the husband is alive, and the widow receives the highest survivor's benefit. In addition, the widow who made as much money as her husband receives less than the widow who earned only half as much as her husband.

Anna Rappaport of William M. Mercer found that the situation for low-income widows who worked is even worse. For example, the wife of a couple with $34,200 in annual pay gets $1,082 as a widow if she never worked, while the wife who brought home half that paycheck gets a widow's benefit of only $674. That is a difference of $408 per month.

The Social Security Administration reports that 24 percent of married and widowed women have their benefits slashed by the dual-entitlement rule. That number is projected to increase to 39 percent by 2040, as increasing numbers of women earn higher wages and work more hours. As Jonathan Barry Forman, former tax counsel to Sen. Daniel Patrick Moynihan (D-N.Y.), puts it, "In short, the Social Security system takes billions of payroll tax dollars from these working women and gives them no greater Social Security benefits in return."

The negative impacts of the dual-entitlement rule are exacerbated by a handful of other factors that make women disproportionately dependent on Social Security benefits. As a result of lower earnings and fewer years of work, women, on average, earn less Social Security benefits than do men. In 1995 male retirees received $810 in monthly benefits while women received only $621, on average. Lower earnings and part-time employment also make it more difficult for women to accumulate private savings for retirement. In addition, women are less likely than men to have employer-provided pension plans. Even if they do have pension plans, they generally save too little because of their moves in and out of the job market.

Those gender-specific issues aside, women, like men, face the larger problem of Social Security's looming debt and declining rate of return. Federal Reserve Board chairman Alan Greenspan estimates that Social Security's unfunded liability is roughly $9.5 trillion. If the government intends to make good on its promise to pay retiree benefits, it will have to raise taxes or cut benefits in order to meet that revenue shortfall. The Social Security board of trustees has estimated that it would take a tax hike of at least 6.3 percentage points to put the program in the black. A tax hike of that size would force workers to pay one-fifth of their wages to Social Security. Of course, cutting benefits is no solution either; benefit cuts would give workers an even worse deal than does the current system. Many of today's young workers can expect to get a negative rate of return from Social Security, according to the nonpartisan Tax Foundation. And, as the American Association of Retired Persons has pointed out, women would suffer most under reform proposals that reduce retiree benefits.

BENEFITS OF FULL PRIVATIZATION

Women, like men, want to know what would be the likely results under a private system in which payroll tax payments were redirected into personal accounts similar to individual retirement accounts or 401(k) plans. Would private accounts increase the overall level of women's retirement benefits? Would private accounts address poverty among widows? Would private accounts end discrimination against working wives?

To answer those questions, Ekaterina Shirley and Peter Spiegler, graduates of Harvard University's Kennedy School of Government, conducted two empirical analyses. The first is a retrospective analysis using actual earnings histories of 1,585 men and 1,992 women who retired in 1981. The researchers compared Social Security benefits with the benefits that hypothetically would have accrued under a private plan with a 7 percent contribution rate, a 6.2 percent rate of return, and 50-

50 earnings sharing between spouses where applicable. Earnings sharing lets married couples split their contributions 50-50 before depositing them into each person's account.

Shirley and Spiegler found that all but .11 percent (approximately 3) of the women collecting benefits would have been better off under the private system. For those women, the difference between the plans was exactly zero—no woman was worse off under the private system. For 3.7 percent (approximately 110) of the women, the difference was less than $2,000. Even though the absolute dollar difference appears small, it is significant relative to total benefits from Social Security. Overall, the median value of the accrued difference between benefits from Social Security and benefits from a privatized plan was $30,000 for single women, $26,000 for wives, $21,000 for divorcees, $23,000 for surviving divorcees, and $20,000 for widows. As a percentage of Social Security benefits, that difference is substantial. The median values of that percentage are 58 percent for single women, 208 percent for wives, 67 percent for divorcees, 58 percent for surviving divorcees, and 97 percent for widows.

In the second analysis, Shirley and Spiegler conducted a prospective simulation since the cohort of women in the workforce today has significantly different labor and marital characteristics than the one that retired in 1981. As complete lifetime earnings histories for women who are currently in the workforce do not exist, the research team simulated the effects of various retirement plans. They compared Social Security; a fully private system; and a two-tiered, or partly private, system. Under the fully private system, the assumed contribution rate is 10 percent. The partly private approach would channel 5 percentage points of payroll taxes into a personal account, with the remaining 7.4 percentage points going to Social Security to finance a "flat benefit" and survivor's and disability insurance. The flat benefit is equal to ⅔ of the poverty rate. As they did in the retrospective analysis, the researchers assumed a 6.2 percent rate of return on invested contributions.

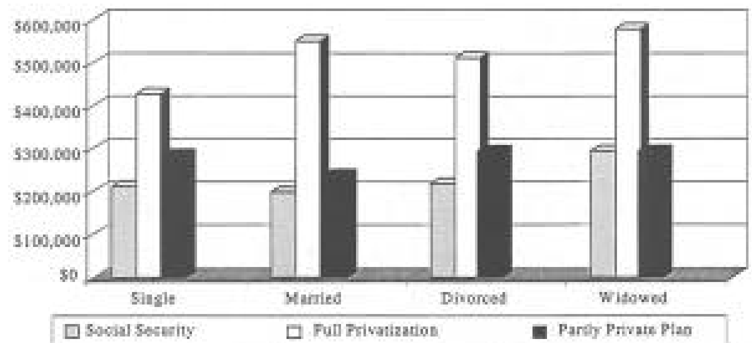
As Figure 1 shows, in every case the fully private system with a contribution rate of 10 percent would bring all women—whether collecting benefits based on their own earnings or as wives, divorcees, or widows—with full earnings histories more than twice the retirement benefits of Social Security.

Moreover, the greater the contribution rate, the greater a woman's financial security in retirement. Thus, the fully private system generates significantly higher retirement benefits than does the partly private, two-tiered system. The partly private system provides only slightly greater benefits than Social Security. The results are similar for women who have moved in and out of the job market, as Figure 2 shows.

In every case, the fully private system brings all women significantly greater benefits than does either Social Security or the partly private system. For example, the fully private plan gives married, divorced, and widowed women (with full or interrupted earnings histories) at least $200,000 more in retirement benefits than does Social Security or the partly private system. That's better than $10,000 per year.

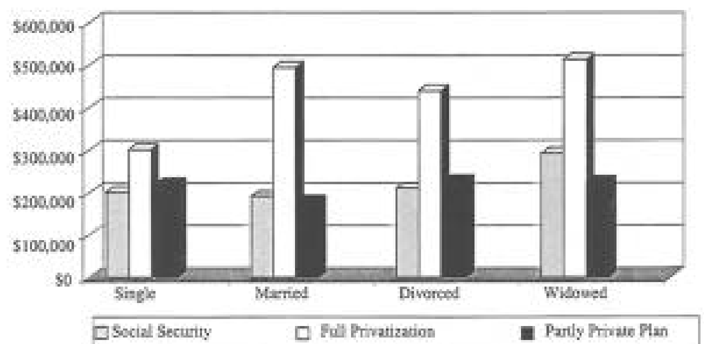
To answer questions about the potential impact of privatization on women with low to moderate incomes, Shirley and Spiegler ran a simulation using half the national mean wage level of women. Figures 3 and 4 show that women with low to moderate incomes (with full or interrupted earnings histories) would do far better under a fully private system than under either Social Security or the partly private system.

FIGURE 1.—ACCRUED RETIREMENT INCOME OF MEAN-INCOME WOMEN WITH FULL EARNINGS HISTORIES



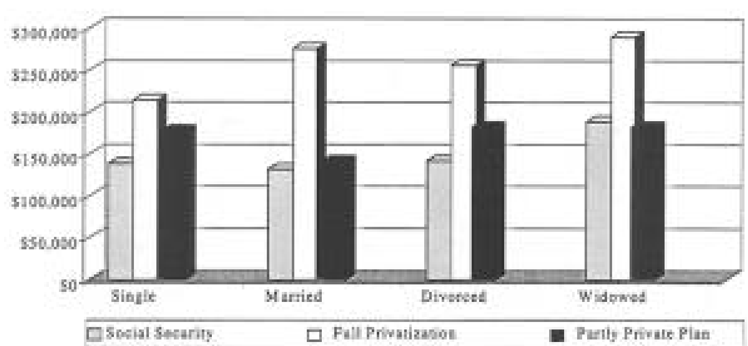
Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 12.

FIGURE 2.—ACCRUED RETIREMENT INCOME OF MEAN-INCOME WOMEN WITH INTERRUPTED EARNINGS HISTORIES



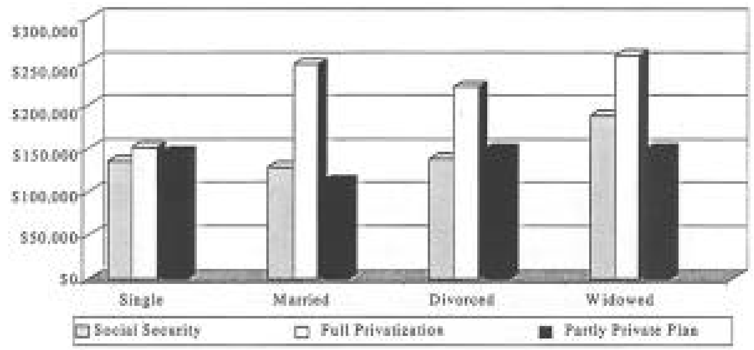
Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 12.

FIGURE 3.—ACCRUED RETIREMENT INCOME OF LOW-INCOME WOMEN WITH FULL EARNINGS HISTORIES



Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 13.

FIGURE 4.—ACCRUED RETIREMENT INCOME OF LOW-INCOME WOMEN WITH INTERRUPTED EARNINGS HISTORIES



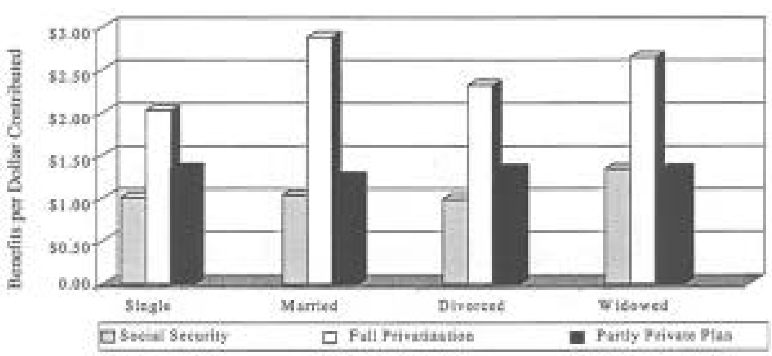
Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 14.

For example, a married woman with a low income who has moved in and out of the workforce could expect to gain roughly $125,000 more in benefits under the private system than under Social Security. That's nearly $550 more per month than Social Security would provide. Even women in the worst-case scenario—low-income single women who do not benefit from the earnings sharing provision and who have moved in and out of the workforce—would receive greater benefits under full privatization than under Social Security, nearly $100 more per month.

One potential concern is that the positive benefits under privatization are simply the result of high contribution rates. To address that concern, Shirley and Spiegler calculated how much each program gives in return for each tax dollar invested. In other words, they wanted to find out whether women were getting their money's worth under each program. For example, Figure 5 shows that a widowed woman with a complete work record would get approximately

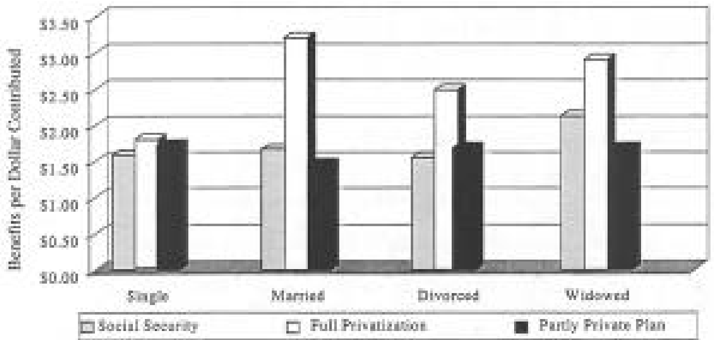
$1 in Social Security benefits for each $1 she contributed; under the fully private plan, she would get approximately $2.50 for each $1 contributed.

FIGURE 5.—MONEY'S WORTH TO MEAN-INCOME WOMEN WITH FULL EARNINGS HISTORIES



Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 12.

FIGURE 6.—MONEY'S WORTH TO LOW-INCOME WOMEN WITH INTERRUPTED EARNINGS HISTORIES



Source: Adapted from Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998, p. 14.

In a final simulation, the researchers used half the national mean wage level of women in each category to examine whether low-income women were getting their money's worth from each program. As Figure 6 shows, full privatization would give low-income women with interrupted earnings histories much more value for the dollar than would either Social Security or the partly private plan.

The money's worth calculations demonstrate that, even taking into account Social Security's "progressive" benefit structure, all categories of women would still get more for their money under a fully private plan.

Shirley and Spiegler's retrospective, prospective, and value-for-the-dollar calculations show how a fully private system with a contribution rate of 10 percent would be able to bring all women—single, married, divorced, or widowed with low to moderate or average income—greater financial security than does Social Security. The implications are real and significant for women, yet many important questions still exist.

CONCERNS ABOUT WOMEN AND PRIVATE ACCOUNTS

People have raised more concerns about women and private accounts than can be addressed in this short paper. However, a brief discussion of a few of the most important concerns should alleviate much uneasiness about personal accounts.

Low-Income Women as Investors

"Because women are more likely to be living in low-income households, they generally have less access to good investment advice." It is unlikely that low-income women would not have adequate access to good investment advice. As the American Association of Retired Persons points out, "Lots of good information on saving and financial planning is free—from AARP, investment companies, the Internet, and your local library. Also, free or low-cost seminars specifically designed for women are offered in many communities." A market-based retirement system will undoubtedly increase investment companies' outreach efforts to women. What is perhaps even more important, however, is that full privatization does not require that every participant be an intelligent or experienced investor. The history of 401(k) plans has demonstrated that workers of all income groups can do well by entrusting their pension benefits to experienced investors who, for the most part, have fulfilled their responsibilities. Under a well-structured system with fully private accounts, low- and high-income workers could expect to receive guidance from fund managers in much the same way. As Melissa Hieger and William Shipman of State Street Global Advisors point out, "There is no need for a worker who chooses the market-based system to know how markets work as long as the pension system is properly structured and sensible guidelines are followed. In fact, most proposals for a privatized national retirement system have regulatory elements that restrict investment strategies that are either too risky or that would be insufficiently aggressive to provide needed retirement benefits."

Low-Income Women and Market Downturns

"Low-income women . . . would be less able than more affluent women to weather market downturns." One way to address that concern is to see how low-income women would have fared historically under a market-based system. That can be done by comparing Social Security benefits with simulated market benefits for low-income workers. For example, Hieger and Shipman compared an initial monthly Social Security benefit with an initial balanced-fund (60 percent equities, 40 percent bonds) benefit for low-income workers born in 1950 and 1970. The low-income worker born in 1950 could expect a monthly Social Security benefit of $668; the balanced-fund benefit would be $1,514. The low-income worker born in 1970 could expect a monthly Social Security benefit of $799; the balanced-fund benefit would be $1,431. In both cases, the market affords low-income workers higher retirement benefits than does Social Security. Those results are consistent with other studies that show higher retirement benefits from markets than from Social Security. If, however, the worst-case scenario arose leaving a worker with insufficient benefits upon retirement, the government could finance a safety net from general revenues. Moreover, if one believes the market-based system is inferior to Social Security, most privatization plans would allow workers the option of staying in the present system. The freedom to choose is particularly important to low-wage women who do not earn enough to save and invest on their own. That inability to invest is largely due to high payroll tax rates. Forcing women to stay in a system that takes 12.4 percent of their wages only to cheat them of a secure retirement is simply unjust. Low-income women should have the freedom to invest their earnings in a way that will increase their chances for a financially secure retirement.

Risk Aversion of Women

"With individual accounts, women may fare worse than men because they are more risk averse." There is some evidence that women tend to be more conservative investors than men; however, many studies that purport to show that did not control for education levels or investment-specific knowledge—factors that may account for some differences in investment behavior. According to the General Accounting Office, people who are given information about their investment choices and potential returns are more likely to invest more than those who do not receive such information. Investment companies compete vigorously to educate and attract female clients. For example, OppenheimerFunds has distributed a 160-page booklet called "A Woman's Guide to Investing." Merrill Lynch, PaineWebber Group Inc., and Smith Barney have similar marketing strategies. In addition, women who have been investing for a long time pursue investment strategies that are very close to those of men. Certainly, experience shows that it is unreasonable to suggest that women, simply because of their gender, are not capable of becoming perfectly competent investors. Finally, in a well-structured private system, women, as well as men, could expect to rely on investment managers to help with investment decisions.

CONCLUSION

Shirley and Spiegler's research demonstrates how full privatization with earnings sharing can address the shortcomings of the current Social Security system. First, both the retrospective and the prospective analysis show that fully private accounts would significantly improve the retirement incomes of women—single, married, divorced, or widowed with low-to-moderate, moderate, or average income—which would begin to address the problem of poverty that exists under Social Security. Second, fully private accounts would end the discrimination currently faced by women under Social Security by ensuring that every dollar earned by a woman had a strictly positive effect on her retirement income. Finally, changing Social Security into a fully funded system would help ensure that future generations grow up without being saddled by unnecessary debt and grow old with financial security.

Notes

I am grateful to Ekaterina Shirley and Peter Spiegler who did the research on which much of this analysis is based. Special thanks to Lea Abdnor for her constructive comments, to Carrie Lips for her expert research assistance, and to Michael Tanner for his support and direction. I take full responsibility for all errors.

Chairman SMITH. Dr. Kijakazi.

STATEMENT OF KILOLO KIJAKAZI, SENIOR POLICY ANALYST, CENTER ON BUDGET AND POLICY PRIORITIES

Ms. KIJAKAZI. Mr. Chairman and members of the Task Force, thank you for inviting me to speak today. I will discuss Social Security's design and how it benefits people of color and women. I will also talk about the potential impact of proposed reforms on these two communities.

The program is particularly important to people of color. Social Security makes up 43 percent of the income of elderly African Americans and 41 percent of the income for elderly Hispanic Americans compared to 36 percent of the income for white elderly.

Chairman SMITH. Would you say that once more?

Ms. KIJAKAZI. Social Security makes up 43 percent of the income for elderly African Americans; 41 percent for elderly Hispanic Americans, and 36 percent for white elderly Americans. This is not surprising, given the low rates of pension coverage for people of color. One-third of elderly African Americans and only one-fourth of elderly Hispanic Americans have pension income, compared to 44 percent of white elderly people.

African Americans and Hispanic Americans are disproportionately represented among low-wage workers. Consequently, it is much more difficult to set aside resources for retirement savings. This places greater weight on Social Security as a reliable, guaranteed source of income.

The argument has been made that Social Security provides a lower rate of return to African Americans because of our shorter life expectancy. This faulty reasoning overlooks the protections Social Security provides for African Americans and low-wage workers. Three aspects of Social Security help to compensate African Americans for our higher mortality rate.

Since African Americans make up a disproportionate share of low-wage workers, we gain from the progressive benefit formula. Second, early retirement is an option that is elected by two-thirds of all workers, including African Americans. Because we have a shorter life expectancy, receiving a reduced benefit earlier provides us with more total benefits than if we waited until we were 65. And third, Social Security is a comprehensive insurance program that includes the disability and survivors insurance programs in addition to the retirement program. African Americans benefit disproportionately from the disability and survivors components of the system.

A study by employees of the Treasury Department found that African Americans have a slightly higher rate of return from Social Security than the general population, or the white population. The same study showed Hispanic Americans have the highest rate of return from Social Security, due to their longevity and because they also benefit from the progressive benefit formula.

Social Security's design also benefits women. Elderly women are more likely to be poor than elderly men. We work 12 fewer years on average, very often because we are caring for family members. We earn lower wages, we are less likely to have pensions. On average, 30 percent of elderly women receive pension income compared to 48 percent of elderly men. And we live longer, which means we must stretch our resources over a longer period of time. Social Security effectively reduces poverty for women. In 1997, three of every five elderly people removed from poverty were women.

The program provides special protections for women, and these include spouse benefits that have been described by Ms. Olsen. A married woman may receive either benefits based on her earnings history or her spouse's. According to data from the Social Security Administration, 63 percent of married women receive benefits based on their spouse's earnings.

Women benefited from Social Security in two ways due to their longer life expectancy. First, survivors' benefits are more often received by women. And second, the cost of living benefits women more than men since we live longer. As a result of these program designs, women receive about 53 percent of benefits while paying only 38 percent of payroll taxes. Social Security is very beneficial for women.

What impact will reform proposals have on people of color and women? Proposals that divert payroll taxes into individual accounts will substantially reduce the guaranteed portion of Social Security benefits and replace these benefits with the promise of investment income. These so-called carve-out proposals increase the long-term imbalance in Social Security and consequently result in a larger reduction in Social Security benefits than otherwise would be necessary.

The recently introduced Archer-Shaw proposal would also have disadvantages for people of color and women. Funding for the individual accounts would likely come from funding for nondiscretionary programs, many of which are beneficial to people of color and women, programs outside of Social Security. The plan would likely undermine the universal support that Social Security now enjoys. Social Security benefits would be reduced by $1 for every dollar in the individual accounts. Those who have the largest accounts, high-wage earners, would receive only modest Social Security benefits for their payroll tax contributions, consequently high-wage earners may reduce their support for the program while low-wage earners remain reliant on the program. Under the Archer-Shaw plan the only group of retirees who could receive an increase in government-funded retirement benefits as a result of the individual accounts would be high-wage workers.

What should be done to address Social Security's imbalance? Several aspects of the Clinton proposal would substantially reduce the imbalance. The plan proposes to use $2.8 trillion of the unified budget surplus to pay down the debt. This would reduce interest payments in the future, and those funds could be used to address Social Security as baby boomers retire.

The plan also proposes to invest a portion of the trust fund in equities. Investments would be made in broadly indexed funds by a politically and financially independent board. This would increase income to the trust fund without the transition costs, the administrative costs or risks of individual accounts.

Finally, the plan would create USA accounts, an individual account system outside of the Social Security system. It would be progressive and would be targeted to low-wage and moderate-wage workers. Solvency can be restored without putting at risk the guaranteed benefit and the features of the program that are most beneficial to people of color and to women.

[The prepared statement of Ms. Kijakazi follows:]

PREPARED STATEMENT OF KILOLO KIJAKAZI, PH.D., SENIOR POLICY ANALYST, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. Chairman and members of the task force, thank you for inviting me to speak. I am Kilolo Kijakazi, a senior policy analyst with the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy organization that conducts research and analysis on issues affecting low- and moderate-income families. We are primarily funded by foundations and receive no Federal funding.

I will discuss how Social Security's design benefits people of color and women and the potential impact of proposed reforms on these communities.

SOCIAL SECURITY'S SUCCESS

Social Security has been one of the country's most successful social programs. It is largely responsible for the dramatic reduction in poverty among elderly people. Half of the population aged 65 and older would be poor if not for Social Security and other government programs. Social Security alone lifted over 11 million seniors out of poverty in 1997, reducing the elderly poverty rate from about 48 percent to about 12 percent. Additionally, Social Security has become more effective in reducing poverty over time. In 1970, Social Security reduced the poverty rate among the elderly from about 50 percent to 17 percent, compared to 12 percent today.

Social Security payments provide the majority of the income of poor and near poor elders. It is the major source of income for 66 percent of beneficiaries age 65 or older and it contributes 90 percent or more of income for about 33 percent of these individuals.

THE IMPORTANCE OF SOCIAL SECURITY TO PEOPLE OF COLOR AND WOMEN

Social Security is particularly important to people of color. Elderly African Americans and Hispanic Americans rely on Social Security benefits more than white elders rely on the program. Social Security benefits make up 43 percent of the income received by elderly African American people and their spouses and 41 percent of income received by elderly Hispanic Americans, compared to 36 percent of the income of elderly whites. This is not surprising given the lower rates of pension coverage for people of color. Pension income is received by only one third of elderly African American people and their spouses and one fourth of elderly Hispanic Americans. By comparison, 44 percent of elderly whites and their spouses receive pension income. Moreover, people of color are disproportionately represented among low-wage workers. It is, therefore, more difficult to set aside savings for retirement to supplement Social Security.

Social Security is also an important source of income for women. The program made up 61 percent of total income received by elderly women in 1997 and it was the only source of income for one out of five elderly women. Compared to men, women have few resources other than Social Security to draw upon in their older years. Women have lower rates of pension coverage and pension income than men. Only 30 percent of women 65 and older had pension coverage in 1994, while 48 percent of men were covered. Of those who began to receive benefits from private sector pensions in 1993-1994, the median annual benefit for women ($4,800) was only half of the amount received by men ($9,600). Additionally, women have lower labor participation rates and lower wages than men; as a result women are more likely to be poor. Women make up the majority of those whom Social Security lifts from poverty. In 1997, three of every five elderly people lifted out of poverty by Social Security were women.

While Social Security is intended to be one leg of a "three-legged stool" for retirement income, the lack of pension coverage and limited resources for savings place greater weight on Social Security as a reliable, guaranteed source of income for many people of color and women.

SOCIAL SECURITY'S PROTECTIONS FOR AFRICAN AMERICANS

The argument has been made that Social Security provides a lower rate of return to African Americans because this community has a lower life expectancy than the general population. Based on this premise, an African American worker would contribute payroll taxes, but would not live long enough to receive Social Security benefits sufficient to achieve the same rate of return as non-African American beneficiaries. This reasoning is faulty, however, as it overlooks important protections Social Security provides for African-American and low-wage workers including disability and survivors insurance.

The design of the Social Security system helps to compensate African Americans for their shorter life expectancy. There are three aspects of the program that provide such protection. First, Social Security's benefit formula is progressive. Benefits replace a larger percentage of pre-retirement earnings for low-wage workers than high-wage workers. Since African Americans are disproportionately represented among low-wage earners, they gain from this formula.

The second feature is the option for early retirement. The Social Security System allows workers either to retire with full benefits at a given age, currently 65, or to retire early with reduced benefits. A worker can take early retirement at age 62. Workers who retire at 62 contribute payroll taxes for three fewer years. They also begin receiving benefits 3 years earlier, with monthly benefits reduced to compensate for the increased number of years during which they will receive benefits.

The reduction in the monthly benefit amount for those who retire early is based on actuarial tables and is intended to make the amount of benefits received from age 62 to the point of death equivalent, on average, to the amount of benefits retirees would receive if they waited until the "normal retirement age" to retire. Over the population as a whole, the Social Security early retirement option is close to a wash the lower monthly benefits paid are designed to offset the increased number of years for which benefits will be received.

The story is different, however, for African Americans. Given the shorter life span for African Americans, the benefits these early retirees receive from age 62 to the end of their lives exceed the benefits they would receive, as a group, if they waited until 65 to retire. Starting to receive benefits several years earlier increases the total benefits they receive and raises their average rate of return. Two-thirds of all workers, including African Americans retire early. Thus, most African-American retirees are partially compensated for their shorter life span by this aspect of Social Security.

The third component of Social Security that mitigates the impact of higher mortality among African Americans is the comprehensive nature of the program. Social Security is not solely a retirement program, but also an insurance system that protects against risks that are unforeseen or for which workers are not sufficiently prepared. In addition to benefits for retired workers, Social Security provides benefits to the worker's spouse and dependents when the worker retires or becomes disabled, as well as survivors' benefits if the worker dies. The divorced spouse of the retired or deceased worker also is generally entitled to benefits.

African Americans benefit disproportionately from the disability and survivors components of Social Security. While African Americans account for 11 percent of the civilian labor force, they comprise 18 percent of the workers receiving Social Security disability benefits in 1996. When a worker becomes disabled, the worker's dependents also become eligible for Social Security benefits. African Americans made up 23 percent of children and 15 percent of the spouses who received Social Security benefits in 1996 because workers in their families were disabled.

As a result of the above-average mortality rates among African Americans, the African-American community benefits disproportionately from the feature of Social Security that provides benefits to non-elderly survivors. Although African-American children comprise about 16 percent of all children in the United States, they made up 24 percent of the children receiving survivors benefits in 1996. African Americans also accounted for 21 percent of the spouses with children who received survivors benefits. Benefits for non-aged survivors are one of the aspects of Social Security most favorable to African-American workers.

Some studies have attempted to estimate Social Security's rate of return for African Americans. The Social Security Administration's (SSA) Office of the Chief Actuary has assessed some of these estimates, such as those used by The Heritage Foundation, as well as the methodology for reaching the estimates. The actuaries found that the methodology was inaccurate and the estimates were wrong. Robert Myers, a former Chief Actuary of SSA, also has sharply criticized Heritage's estimates as fundamentally flawed and invalid.

Most of these studies faced a major limitation. They did not have access to the one database on actual earnings records of workers and actual benefits of retirees, the Social Security Administration's Continuous Work History database. This information is confidential and is not released to the public so that the privacy of workers and beneficiaries will be protected. These data have been available only to Treasury and SSA researchers. One study that had access to these data was conducted by employees of the Treasury Department (Duggan, Gillingham, and Greenlees). These researchers found that African Americans had a slightly higher rate of return from Social Security retirees and survivors benefits than the general population. A second study by the Social Security Administration also used this database and looked specifically at disability insurance. It shows that African Americans received substantially more benefits from Social Security Disability Insurance in relation to the taxes they have paid than whites do. Thus, despite the shorter life span of African Americans, aspects of the programs such as the progressive benefit, early retirement and comprehensive insurance, offset the effects of higher mortality rates for this community.

SOCIAL SECURITY'S PROTECTIONS FOR HISPANIC AMERICANS

Social Security also is of particular value to Hispanic Americans for another reason. Hispanic retirees live longer, on average, than other Americans. The average American who reaches 65 (including both men and women) will live an additional 17½ years, while the average Hispanic reaching 65 lives an additional 20½ years. Those with a longer life span receive more monthly benefit checks from Social Security. Furthermore, Social Security's annual cost-of-living adjustment a feature most private annuities do not have is of greater value for those who live longer.

Hispanic Americans thus benefit doubly from Social Security; they benefit both from Social Security's provision of benefits that keep pace with inflation and cannot run out no matter how long one lives, and also from Social Security's progressive benefit formula, which ensures that individuals who earned lower wages and/or had fewer years in the workforce receive larger monthly benefit amounts, in proportion to the wages they earned and the taxes they paid, than other workers do. Since Hispanic retirees on average have lower wages and fewer covered years of employment and also live longer than other workers, they receive benefit levels that return the taxes they paid in fewer years than average retirees do, while also receiving benefits for more years than the average retiree.

Hispanics consequently are one of the groups for which Social Security is most beneficial. A recent Social Security Administration fact sheet notes that Hispanic American beneficiaries "on average receive a higher rate of return on taxes paid." A recent analysis by the Deputy Chief Actuary of the Social Security Administration explains that "a somewhat higher rate of return for Hispanic Americans is to be expected, based on the higher life expectancy for Hispanic Americans, and the fact that Hispanic Americans have lower than average earnings."

SOCIAL SECURITY'S PROTECTIONS FOR WOMEN

Several factors within the Social Security benefit structure help to compensate for the lower earnings of women. The benefit formula helps in two ways. First, the benefit formula is made progressive by providing low-wage workers with a substantially higher percentage of their pre-retirement earnings than higher wage workers. This aspect of the formula favors women, since their wages are lower than men's wages. In fact, Social Security replaces 54 percent of the average lifetime earnings for the median female retiree and 41 percent for the earnings of the median male retire. The second way in which the benefit formula helps women is through the determination of the worker's average wage over his or her work life. This average wage is a critical part of the benefit formula. The average wage is the amount of earnings to which the progressive formula is applied. In determining the average, five of the lowest years of a worker's earnings (including years with no earnings) are eliminated from the 40 years of earnings history that are reviewed. Since women are more likely than men to have dropped out of the labor force or to have worked part time, the elimination of the five lowest years helps to raise the average earnings figure used to compute their Social Security benefits.

In addition to the progressive benefit formula, Social Security provides other compensation to married women. A married woman can receive either a benefit based on her own earnings history or a spouse benefit equal to 50 percent of her husband's benefit, whichever is larger. Although the number of women in the workforce has grown tremendously since the 1960's, some 63 percent of women beneficiaries 65 and older receive benefits based on their husbands' earnings records. Given the longer life span for women, they also benefit greatly from the survivors insurance component of Social Security. An elderly woman who outlives her husband can receive a survivors benefit that is based on her own earnings history or she can receive 100 percent of her deceased husbands benefit, whichever is larger. Approximately 74 percent of elderly widows receive benefits based on their deceased husbands' earnings. A woman is eligible for spouse and survivors benefit even if she is divorced, as long as she was married for 10 years and did not remarry before age 62.

Finally, the annual cost-of-living adjustment particularly benefits women due to their longer life span. Without this annual increase in benefits, the buying power of elderly women would decline substantially as they grow older.

As a result of these protections, women receive a higher rate of return from Social Security than men. Data from the Social Security Administration indicate that women pay 38 percent of the payroll taxes, but they receive 53 percent of the benefits.

THE NEED FOR REFORM

Although the Social Security System has clearly served as an important source of income for the general population, including African Americans, demographic changes necessitate reforms in the program to maintain solvency. The baby-boom generation is aging and will begin retiring in large numbers after 2010. By 2025, most of this group will be 65 or older.

Moreover, rising life expectancy will further increase the number and proportion of the population that is elderly. The Social Security actuaries' projections, reported by the Social Security trustees, show the number of people age 65 and older will nearly double from 34 million in 1995 to 61 million in 2025. During that period, the proportion of the total population that is elderly will grow from 12.5 percent to 18.2 percent. There also will be a decline in the rate of growth of the working-age population. As a result of these various changes, the ratio of workers to Social Security beneficiaries will decrease from just over three-to-one today to two-to-one in 2030, and remain at approximately this level through 2075, the last year of the actuaries' projections. At that point, the elderly will comprise 22.7 percent of the total population.

Social Security payroll tax revenues currently exceed benefit payments and the trust funds are accumulating assets. The demographic changes that lie ahead, however, will result in substantial increases in benefit payments in coming decades and create an actuarial imbalance in the program over the long-term. The actuaries project that the assets in the trust funds will be exhausted by 2034.

After 2034, the trust funds will be dependent entirely on payroll tax collections for income. From that time on, Social Security will be insolvent because it will not have sufficient annual income to make the full benefit payments to which its beneficiaries are entitled by law. This does not mean Social Security will collapse at that time and have no funds to pay any benefits; to the contrary, the problem is that after 2034, incoming payroll taxes are projected to be sufficient to cover about 70 percent of the benefit payments, rather than 100 percent of these costs. Policymakers need to make policy changes that eliminate this shortfall.

DRAWBACKS OF SOME INDIVIDUAL ACCOUNT PROPOSALS

Some proposals to reform Social Security would be particularly disadvantageous to people of color and women. Proposals to fully or partially privatize Social Security by diverting payroll taxes from the Social Security trust funds to individual accounts would have a detrimental impact on low-wage workers, people of color, and women.

How is it possible for advocates of individual accounts that replace Social Security benefits to claim that their proposals will benefit people of color , women and low-wage workers? The answer is proponents of these accounts often fail to factor in the costs and risk of such individual accounts when determining the rate of return for the accounts. There are three such types of costs transition costs, the administrative costs, and the cost to convert accounts to annuities.

If retirement benefits are privatized, the payroll taxes that are currently used to finance Social Security retirement benefits will instead be deposited in individual accounts. That will create a financing gap funds will be needed to fulfill the government's obligation to pay Social Security benefits to current retirees and those nearing retirement. Robert Reischauer, a senior fellow at the Brookings Institution, addressed this point in his statement at the White House Forum on Social Security in New Mexico, July 27, 1998. "Whether we retain the existing system or privatize it, this unfunded liability will have to be met unless we renege on the benefits promised to today's elderly and near elderly. Dealing with the unfunded liability inescapably will reduce the returns workers can expect on their contributions."

Under a privatized system that diverts all payroll taxes into individual accounts, workers would have to pay a new tax to continue financing the Social Security benefits of current and soon-to-be retirees. As senior researcher Paul Yakoboski of the Employee Benefit Research Institute has testified, "Because the current Social Security system is largely pay-as-you-go, most of what workers pay into the system funds today's benefits. . . . [O]n top of paying current benefits, workers moving to a privatized system would have to pay 'twice' for the benefits going to today's beneficiaries and again to their own [personal] accounts."

A study conducted by the Employee Benefit Research Institute incorporated transition costs into its calculations. It found that for workers who are 21 today and receive low wages, the rate of return would be lower under the individual accounts options it examined than under all options it examined to restore long-term balance to Social Security without individual accounts.

Administrative costs further reduce the rate of return for individual accounts. Accounts that are designed like IRA accounts will result in significant administrative costs and management fees, which would be paid out of the proceeds of the accounts and consequently reduce the amounts available in those accounts to pay retirement benefits. Moreover, additional costs are incurred when the funds in these accounts are converted to lifetime annuities upon retirement.

Based on data on IRA accounts, two eminent Social Security experts Henry Aaron of the Brookings Institution and Peter Diamond of M.I.T. have estimated that the administrative costs for retirement accounts like IRAs would consume 20 percent of the amounts that otherwise would be available in these accounts to pay retirement benefits. They note that a 1-percent annual charge on funds in such accounts eats up, over a 40-year work career, 20 percent of the funds in the accounts. The 1994-1996 Advisory Council on Social Security estimated an annual charge of 1 percent on the assets in privately managed individual accounts.

Furthermore, recent financial data indicate that a 1-percent annual charge is a conservative estimate. In 1997, the average annual charge on stock mutual funds was 1.49 percent of the amounts invested in those funds. In addition, Diamond has noted that administrative and management costs consume approximately 20 percent of the amounts in individual accounts in Chile's privatized retirement system. Research by Mamta Murthi, J. Michael Orszag and Peter R. Orszag showed that the combination of these fees and annuitization costs eat up an average of 43 percent of the funds in privatized retirement accounts in Great Britain.

Some of these costs are fixed-dollar expenses that do not vary with the size of an account. As a result, such costs would generally consume a larger percentage of the amounts in smaller-than-average accounts (and a smaller percentage of the amounts in large accounts). This suggests these costs would, on average, consume more than 20 percent of the funds in the accounts of lower-wage workers. That is of particular significance to African-Americans since, as a group, they receive lower-than-average wages and would consequently have smaller-than-average accounts.

To these costs must be added the costs of converting an individual account to an annuity upon retirement. The leading research on this matter indicates that an additional 15 percent to 20 percent of the value of an individual account is consumed by the costs that private firms charge for converting accounts to annuities. The General Accounting Office recently noted that "While individual annuities are available, they can be costly especially relative to annuities provided through Social Security."

Taking all of these costs into account both administrative and management fees and the costs of converting accounts to annuities Aaron estimates that at least 30 percent and as much as 50 percent of the amounts amassed in individual accounts similar to IRAs would be consumed by these costs rather than being available to provide retirement income. (While the administrative cost would be lower for accounts centrally managed similar to the Federal employees Thrift Savings Plan, the cost would still be significantly higher than the administrative cost for Social Security.)

In addition to the costs of these individual accounts, there are some risks. Retirees who are particularly lucky or wise in their investments could receive retirement income from individual accounts that more than offsets their loss of Social Security benefits. But retirees who are less lucky or wise, including those who retire and convert their account to a lifetime annuity in a year the stock market is down, would likely face large reductions in the income they have to live on in their declining years.

A recent GAO report takes note of these issues. "There is a much greater risk for significant deterioration of an individual's 'nest egg' under a system of individual accounts," the GAO wrote. "Not only would individuals bear the risk that market returns would fall overall but also that their own investments would perform poorly even if the market, as a whole, did well.

This is a concern for workers in general surveys have found Americans are not very knowledgeable about financial markets and a particular concern for lower-wage workers, who generally would not be able to afford as good investment advice as individuals at higher income levels. Moreover, lower-income groups have less investment experience and would be more likely to invest in an overly conservative manner because they could not afford to expose the funds in their accounts to much risk.

African Americans, Hispanic Americans and women make up disproportionate shares of the low-income population. As a result, they would be likely to receive a somewhat lower-than-average return on amounts invested even while, as explained above, they would likely pay an above-average percentage of their holdings in fees.

SHORTCOMINGS OF THE ARCHER-SHAW PLAN

Representatives Bill Archer and Clay Shaw recently introduced a Social Security reform plan with individual accounts that attempts to address several of the limitations previously noted. Under their plan, long term solvency would be restored, beneficiaries would be guaranteed to receive the benefit levels to which current law entitles them, and Social Security taxes would not be increased. However, there remain several shortcomings that have important consequences for people of color and women.

The Archer-Shaw plan makes large transfers of general revenue to Social Security that could place too great a strain on the rest of the budget for much of the next half century. If most or all of the non-Social Security surplus is consumed by tax cuts, as the Congressional budget resolution envisions (or by a combination of tax cuts and upward adjustments in discretionary spending levels, as could result from negotiations between Congress and the Administration), there would be only one place from which the plan's individual accounts could initially be funded the Social Security surpluses. This evidently is what the plan's sponsors have in mind.

After about 2012, however, the plan's costs would exceed the Social Security surplus. For several decades after that, financing the individual accounts the plan would establish would result in substantial problems for the rest of the budget and likely lead to large cuts in other programs, increases in taxes, or budget deficits. The cost of the plan would be substantial in these years. The plan's costs include not only the cost of depositing funds into the individual accounts but also the cost of higher interest payments on the Federal debt. (Higher interest payments would have to be made because large sums would have been deposited in the individual accounts rather than used to pay down the debt.) According to the Social Security actuaries, the net costs of the Archer-Shaw plan the costs of the deposits into individual accounts and the higher interest payments on the debt, minus the savings the plan would produce in Social Security costs would run from $300 billion to $600 billion a year each year from 2016 through 2042.

With the Social Security surpluses no longer able to cover such costs and with little, if any, surplus likely to remain in the non-Social Security budget in these years because the baby boomers will be retiring in large numbers and costs for health care programs and some other expenditures will be mounting accordingly financing the individual accounts is likely to entail substantial tax increases or program cuts if policymakers seek to avoid sizeable deficits.

Some of the programs that would be cut are likely to be programs that benefit people of color and women. Thus, while their Social Security benefits are guaranteed, other programs of importance to their lives could be reduced.

The plan also raises equity concerns. The only group of retirees who could receive an increase in government-funded retirement benefits under the plan would be upper-income workers. Yet a broad array of Americans, including many of average or modest means, might have to absorb cuts in other benefits or services or tax increases to help finance the individual accounts after 2012.

Finally, there is a high degree of risk that the plan would lead over time to a substantial weakening of support for Social Security. This is one of the plan's most significant weaknesses over time, it could undermine the system it seeks to save. Under the plan, many middle- and upper-middle-income workers would receive only a modest Social Security benefit, which would equal the difference between the annuity payment from their individual account and the Social Security benefit level to which they are entitled. Social Security would appear to provide little in return for the 12.4 percent of wages these workers and their employers pay into the Social Security system. As a result, higher-wage workers may become less supportive of Social Security while low-wage workers remain reliant on the program. The universal support that the program now enjoys would be placed at risk.

Moreover, the plan could invite misleading comparisons. Many retirees would likely compare the annuity benefit their individual account would provide which would have been financed with annual deposits equal to 2 percent of their wages to their Social Security benefit, financed with 12.4 percent of their wages. They could conclude Social Security was a bad deal and the law should be changed to shift large sums from Social Security to individual accounts. As a number of leading Social Security analysts have written, however, such a comparison would be highly misleading; it would ignore the fact that Social Security payroll taxes must finance benefits to previous generations of workers, pay for disability and survivors insurance, and finance the provision of more adequate benefits to low-wage workers and to spouses who spent years out of the labor force raising children, among others. If the same amount of additional funding were provided directly to the Social Security trust funds and allowed to be invested in a similarly diversified manner, the Social Security trust funds would secure a higher rate of return than the Archer-Shaw individual accounts, since the administrative costs of establishing and maintaining 150 million individual accounts would be avoided.

AN ALTERNATIVE APPROACH

President Clinton has proposed an alternative plan to reform Social Security and several aspects of the plan could be beneficial to people of color and women. In his 1999 State of the Union address, President Clinton proposed to transfer 62 percent of the unified budget surplus to the Social Security Trust Funds. These funds would be used to pay down the debt held by the public.

The President's plan would also invest 15 percent of the trust funds in the equities. These investments would be overseen by a new independent institution outside the executive branch that would be designed to be insulated from political pressures. The equity investments would be limited to passive investments in broad index funds. Investing a portion of the trust funds in equities markets would enable Social Security to earn higher rates of return and meet its long-term obligations without having to reduce benefits or raise taxes as much as would otherwise be necessary.

If a goal of Social Security reform is to raise the rate of return to Social Security, it is not necessary to create individual accounts to achieve this goal. Increased rates of return are not the result of individual accounts; they are the result of advanced funding (that is, setting aside the funds needed to pay Social Security benefits in advance). By investing the Trust Funds in equities, advanced funding can be achieved without the transition costs or administrative costs of individual accounts.

By contrast, the Archer-Shaw plan is structured in a way that renders it inefficient. The plan would transfer general revenues to individual accounts that would be managed by Wall Street brokerage firms and other private fund managers and enable these firms to take substantial sums out of the accounts in commissions and management fees, only to have nearly all of the proceeds from these individual accounts then transferred back to the Social Security trust funds to help pay Social Security benefits. Based on the actuaries' assumptions regarding these costs, the administrative and management costs that would be paid on these accounts would total approximately $350 billion over the system's first 30 years, equaling $34 billion a year by 2030 and larger amounts in years after that. It makes little sense to incur costs of this magnitude.

A third component of the President's plan is to commit 12 percent of the unified budget surplus to the creation of USA Accounts. The President's plan would preserve the guaranteed benefit that is the cornerstone of the Social Security system and would not divert any revenue from the trust funds. Furthermore, the USA accounts are designed to be progressive in several ways. They are targeted to low- and middle-income earners and their spouses. The government would contribute the same amount of money ($300) to each worker's account. This means the contribution will represent a higher percentage of income for low-wage earners than for high wage earners. And under this proposal, the government would also provide progressive matching contributions to workers who add their own savings to their accounts or to a 401(k)-type employer-sponsored plan. Low- and moderate-income workers would receive a dollar-for-dollar match. This government match would be phased down to 50 cents for higher-income workers until the income eligibility ends.

Not only do these accounts primarily benefit low- and moderate- income workers, they incorporate the spouse protection feature of Social Security that would benefit women. Spouses, both current and divorced, are eligible for USA accounts even if they do not work outside the home.

This proposal would not alter the basic structure of the Social Security system that has played such a vital role in the economic well-being of people of color and women. At the same time, it would encourage savings using a design that targets resources to workers who would benefit the most from an increase in their retirement income.

Chairman SMITH. Dr. Kijakazi, if I say it enough, I think I am going to come closer every time.

We will stay pretty close to the 5 minutes for members and if we have a chance to go around a second or third time, we will.

Dr. Kotlikoff, let me start with you.

If we move ahead with your suggestion to move to a partially privatized system, how would you accommodate the problems that have been described? Would you make the system progressive, and how might you do that for the disadvantage it might have to lower-income workers?

Mr. KOTLIKOFF. I think that the concerns that were just raised about the treatment of women and people of color under a privatized system may arise under certain proposals, but not under the plan that I have developed with Jeff Sachs, who is an economist at Harvard. Our plan has been endorsed by 65 top academic economists, including three Nobel Prize winners.

Our plan would have people contribute 8 percentage points of their 12.4 percentage point payroll tax to individual accounts. The other 4.4 percentage points would be left to pay for the survivor insurance and the disability insurance programs. If you die early or if you become disabled, you would still get the same Social Security benefits you would otherwise get from those programs.

It is just the retirement portion of Social Security that would be privatized. You and your spouse would contribute 8 percent up to the covered taxable maximum, and that would be divided 50-50. Each spouse would get the same size account. So you would have protection for dependent spouses. Mothers who stay home with children would have an equal-size account to the husbands.

The plan also has a matching contribution made by the government, which is calculated on a progressive basis. So you can have as much progressivity under our plan as you would like. All account balances would be invested in a global index fund that is market-weighted, just like the S&P 500. All you need is a computer to operate this fund, but you wouldn't be just investing in U.S. stocks, you would also be investing in U.S. bonds and stocks and bonds that are listed throughout the world.

Since our plan puts everyone in the same portfolio, everyone gets the same fair deal and the same good deal that the marketplace can deliver. Hence, the concern about some people earning higher rates of return than others would be eliminated in our plan.

Between age 60 and 70 your account balances would be gradually sold off every day on the market and transformed into an inflation-protected annuity. This would protect older people from spending their money too quickly. They would be assured of an annuity until they passed away. If you died prior to age 70, anything that wasn't annuitized at that point would be bequeathable to your heirs.

In contrast to our purpose, we now have a system where the children of the poor end up not receiving any inheritances when their parents die because all of the earnings of the parents are completely covered by Social Security and they are not able to accumulate any wealth for their old age.

The only issue left to discuss is paying for the benefits under the old system. We would give people their accrued benefits when they reached retirement—that is, the benefits they had earned under the old system as of the time of the reform. For example, at age 65, Social Security would pay me benefits based on my earnings record up through my current age, which is 49, with zeroes filled in on my earnings record thereafter. They would treat me the same as if I were to leave the country right now and never contribute another penny to Social Security. I would still get a benefit, which is my accrued benefit at retirement.

So, in the aggregate, everybody is in the new system at the margin, but everybody gets their accrued benefits, and in the aggregate, there is no new accrual of benefits under the old system. Now paying off the old accrued benefits means paying off this time path of benefits, which, declines to zero. How would we do this? The answer is a business cash flow tax. In the long run, you would have no payroll tax to pay for the retirement portion of Social Security, but you would have a very vibrant, fair, progressive, protective system for American workers that would be yielding a terrific rate of return on the marketplace.

Chairman SMITH. Ms. Olsen, do you have any specific suggestions to accommodate the reduced benefits of private investment in terms of the benefits collected by a nonworking spouse or a partial-time-working spouse?

Ms. OLSEN. Well, what you would have is a system called "earnings sharing," and there are some details on it in my paper. So, for example, earnings sharing is a fancy way of saying that a husband and wife would split their retirement income with each other, and you can do it from the day that you get married. So, for example, if I decide to become a stay-at-home wife and not work for the next 20 years or something, every time my husband's payment would go off into his account, half of it would go into my account. So I would own my own account and he would own his own account, and in that case, I could accumulate funds on my own.

In addition, if I reenter the work force at some point, which is the most likely situation for most women, I would also be able to start contributing to my account and divide it with him as well. So both of us end up with significant pools of retirement income in the end.

I wanted to address just really briefly this notion, when you asked Larry about the progressive benefit structure and how you would compensate for it. You wouldn't need to necessarily put a progressive benefit structure in because the returns in a private system are so much greater than you get from Social Security. The reason you have to have a progressive benefit structure under Social Security is because the money is not saved or invested for the future. When you do that, you eliminate that need and people can stand very independently with their own accounts.

Chairman SMITH. Congresswoman Rivers.

Ms. RIVERS. I have a couple of questions. One is a clarifying question to Mr. Kotlikoff.

When you mentioned earlier that you would need an additional 4 percent, the numbers I have seen are 2.2 percent. Is the 4 percent a product of delay, the longer you wait, the more you need?

Mr. KOTLIKOFF. No. Social Security's figure was 2.2 last year. I think the more recent number is 2.07, given the more favorable economic news. But the 2.07 figure is based on paying for the system for just 75 years. If you ask Steve Goss, who is the Deputy Chief Actuary at Social Security, to not truncate his analysis, but rather to tell you how much it would cost to pay for Social Security on an ongoing basis (because there are huge deficits in the year

1976, 1977 and the year after), Steve will tell you the required tax hike is double or more.

Ms. RIVERS. So for perpetuity?

Mr. KOTLIKOFF. Yes. Let me point out that right now we are 16 years beyond 1983. Back in 1983 when Robert Dole and others, quote, "saved Social Security," they only looked 75 years into the future. But there were huge deficits in the outyears back then.

Since 1983, we have brought those big deficits into our current 75-year window. So if you really want to solve this problem, you have to solve it once and for all. You can't do so by forecasting based on a truncated horizon.

Ms. RIVERS. Unless the human genome people we talked to a few times are correct, we are all going to live to be 130 years old, and then nobody's plan is going to work.

Mr. KOTLIKOFF. Good news, bad news. It would be tough to work.

Ms. RIVERS. The other question I have is, to go back to the progressive structure, both Ms. Olsen and Dr. Kotlikoff spoke to it. Because at some point, Mr. Kotlikoff, you talked about the fairer system, a fairer system. And one of the hallmarks of the system has been that people at the lower end actually draw more recognition that they will need more to live on. And even though the argument is that you will get tremendous returns, we had a progressive system built in when people were getting three times or four times what people put in. From the very beginning, there has been a progressive structure. So I don't think it is based on what the return is going to be; there is a recognition of the people at the lower end.

What happens to them?

Mr. KOTLIKOFF. Well, in our proposal you would have the government providing a progressive matching contribution. The first so many dollars would be matched at a certain rate, and the next so many dollars would be matched at a lower rate, and the next would be matched at an even lower rate. This would provide a progressive match, just like the President's USA accounts proposal.

By the way, I forgot to mention, our plan calls for the government to make contributions on behalf of the disabled, so they would be protected as well. Again, we have as much progressivity as you would like to design, we have protection for dependent spouses, we have everyone earning the same rate of return, and we have this done on a large enough scale so it is all very inexpensive in terms of the transactions costs. Since everybody is invested in the same portfolio, one could buy that from your local investment company at a very low, competitive rate. Alternatively, Congress could just run the whole thing through the Social Security trust fund and let it play the Provident Fund and manage these accounts. Bear in mind though that there is basically no management to be done. It is just investing with the computer.

Ms. RIVERS. The ongoing costs that the government would continue to provide matching for lower income, paying fully for disabled, would those be a product of payroll taxes?

Mr. KOTLIKOFF. Under our plan, we are calling for a business cash flow tax that would probably start around 8 percentage points and go down through time to probably around 2 or 3 percentage points. It would pay for the benefits under the old system that have been accrued, that you still have to pay off; and it would also pay for contributions for this progressive match and also contributions on behalf of the disabled.

Ms. RIVERS. So that, essentially, employers would continue to bear the same burden they have up until now?

Mr. KOTLIKOFF. No, the burden on workers would fall because their 8 percentage point payroll tax is now going to be private saving into their private account. They are going to get a tax cut. However, they and everyone else are going to pay this business cash flow tax, which is effectively a consumption tax. But this is a broad-based tax, so the middle class and rich elderly, as well as the workers, would be paying this consumption tax.

On balance, the burden on young workers would actually be lower in moving to this kind of a tax structure. The poor elderly would be completely insulated because they are living off of Social Security. Those benefits are indexed to the price level, so their purchasing power is completely protected under our plan. It is just the rich and the middle class elderly that would, in effect, have to pay this consumption tax.

Ms. RIVERS. Ms. Olsen, one of the questions I had is regarding the inequities you mentioned, and you gave several, but the one that stood out was women, because even though women may draw at a lower rate, isn't it in fact true that women live longer and therefore may draw, in fact, more than men do from the system?

Ms. OLSEN. Yes, absolutely.

Ms. RIVERS. So what is the inequity?

Ms. OLSEN. The problem is that what happens under the dual entitlement rule is that you can pay payroll taxes for 40 years and get nothing in return. Instead, you get a benefit based on being a spouse.

If you look at the alternative to that, which would be a personal retirement account, every dollar that you earn would work for you, regardless. So in other words, under a private system you would utilize that, all your years of contributions would actually work for you, whereas in the present system, they are sort of tossed away.

Ms. RIVERS. The inequity is between what you would draw under the current system versus what you project someone would draw under a privatized system? Is that the inequity you are talking about?

Mr. KOTLIKOFF. Could I just respond? Let me put an economist's spin on this.

I would say that the way to think about this is that at the margin, women in this situation aren't getting anything back, so the inequity is that they face a higher marginal tax rate. On the other hand, their average tax is lower under the system. So women are being given something for doing nothing, but then they are being told, "if you work, you are going to pay, all together, 15.3 percent of your pay to Social Security and Medicare, and at the margin get nothing more back for that contribution.

Ms. RIVERS. But since she has the choice of the benefits that are directly reflective on what she has done as a worker or those as a spouse, she could choose the higher.

Mr. KOTLIKOFF. It is not inequitable in the sense of the total benefit or average benefit, but it is inequitable in terms of the incentives that people face to work. You are telling women, if you work, you lose this part of your wages and you get nothing back in return.

Chairman SMITH. The gentlewoman's time has expired.

Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Ms. Kijakazi, you indicated, and I believe indicated correctly, that the Clinton proposal would reduce the government's interest costs; however, CBO has shown that the public debt would increase dramatically under the Clinton plan. Wouldn't we have to pay interest on all of that debt as well?

Ms. KIJAKAZI. My understanding is that the public debt is what is being reduced. The only portion that is not being affected is the debt within the government, so it is the public debt that is being reduced and the interest on that public debt is being reduced.

Mr. HERGER. Right. But interest on the government debt being increased far more, or transferring from public debt, which I believe is a positive thing, but I believe it is only a part of the equation.

The other part of the equation is the tremendous amount of debt that is government debt that ultimately is owed by our children and grandchildren and those who come after us. I just would like to, if I could, clarify that somehow we are not forgetting or negating that debt as though somehow it doesn't count, or that somehow our Nation and our children aren't going to have to pay for that.

Ms. KIJAKAZI. I think what you are referring to are the credits to the Social Security trust fund.

Mr. HERGER. Right, correct.

Ms. KIJAKAZI. That would be in the form of Treasury securities, and——

Mr. HERGER. IOUs.

Ms. KIJAKAZI. And to date, the government has never defaulted on any of its Treasury securities, for Social Security or bonds held by the public.

Mr. HERGER. Who would pay for that? Why is that true? Where does that money come from?

Ms. KIJAKAZI. As benefits need to be paid, the Treasury securities are redeemed by the Treasury using incoming revenue.

Mr. HERGER. But the point is, they are redeemed by somehow going into debt, by somehow—the ones who ultimately owe it, and I am very concerned, because it seems like every time we go through this, we kind of go over that very quickly as though it doesn't count.

But the fact is, we are trading present debt, which is public debt, we are trading that for future debt which will—in which the only ones that will pay for that will be future taxpayers. There isn't any company or any business that somehow is making money to generate paying for that. It is only taxpayers. That is the only point, I believe, that is crucially important that we make at the same time we make the fact of the positive gain, which—I do believe it is positive, of reducing public debt, reducing the debt which helps to lower interest rates.

But it is not like it doesn't count, and that is the only point I would like to make.

Ms. KIJAKAZI. Yes, and the point that I was attempting to make is that through the President's plan, the surplus is being preserved by paying down the debt, as opposed to using the surplus for additional spending or for tax cuts. Reducing the debt creates savings by reducing interest payments. These savings can be used to help meet future fiscal demands, especially when the baby boom generation retires.

Mr. HERGER. Right. But again, that is only less than half of the equation. The other more than half of the equation is, we are creating this huge government debt that is owed by our children and our grandchildren to be paid through taxes.

Let me move on to another question, and that is just a—the present, or at least—I don't want to word this in the wrong way, but I gather from your testimony that our present Social Security system, what is so important with it is that we do pay the women, I believe you mentioned, and minorities, people of color, I think you mentioned that they are getting—I don't want to put words in your mouth, I am trying to think back as you said it. Percentage-wise were you saying that they are receiving a——

Ms. KIJAKAZI. Women receive 53 percent of benefits as a result of the progressive benefit, the spouse benefit, survivor's benefits, their longer life expectancy, and the cost of living adjustment.

Mr. HERGER. And the point being you are receiving a higher percentage than some of the others are receiving. Is that correct?

Ms. KIJAKAZI. Women receive a higher percentage of the benefits from Social Security than men, yes.

Mr. HERGER. Right. Therefore, the way the Social Security is working, at least in that aspect, is a positive.

Ms. KIJAKAZI. Yes, there are protections for women.

Mr. HERGER. OK. Having established that and just going back to that, what is your feeling of the proposal that just came out by Chairman Archer of Ways and Means and Chairman Shaw in which they would preserve Social Security the way it is, but add to it a system of independent accounts that, unlike the President, where the government would own them?

And to some extent, they are somewhat similar, but to another extent they are very, very different, in that the individuals would own it, which would be above and beyond what was going into Social Security to benefit them. And they would be guaranteed at minimum the Social Security that they have now.

What would be your thoughts on that proposal as something being offered to help this incredible problem we have now of running out of money in 2013 or 2014?

Ms. KIJAKAZI. There are several shortfalls that we are concerned about. One has to do with the funding. If, as the budget resolution envisions, the non-Social Security budget is used for tax cuts, that leaves an amount equivalent to the Social Security portion of the budget to fund these individual accounts.

Mr. HERGER. I believe that would be part of the tax cut, that would be a part of the tax cut.

Ms. KIJAKAZI. And the rest of the funding for the——

Mr. HERGER. That would be in excess of and not including the surplus of Social Security, so it would be—in other words, 100 percent of Social Security would be saved or lock-boxed or however you want to term it, and then it would be above and beyond that of a surplus that would go to that. I believe that is how the recommendation is meant to work.

Ms. KIJAKAZI. My understanding is that the Archer-Shaw plan would use general funds to fund these individual accounts, and if the non-Social Security portion of the surplus is set aside for tax cuts, that leaves an amount equivalent to the Social Security surplus to fund these individual accounts.

Estimates show that the cost for the Archer-Shaw plan would exceed the Social Security surplus around 2012. Thereafter, funds have to come from large cuts in other programs, tax increases, or budget deficits. In order to continue funding these individual accounts it is likely that cuts will be made in discretionary programs, many of which are beneficial to people of color and women.

A second concern is that these accounts would not be sustainable and that they would undermine universal support for Social Security. If, as the plan is designed, Social Security benefits are reduced by $1 for every dollar that is in these individual accounts, then individuals who have the largest accounts, which would be the high-wage earners, would be getting back very little from Social Security, while lower-wage earners who have smaller accounts would be getting back the bulk of their retirement income from Social Security.

Chairman SMITH. Dr. Kijakazi, I am going to excuse myself and interrupt you, because the gentleman's time has expired.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Dr. Kotlikoff, if I understand the proposal, you would fund the transition costs with an 8 percent consumption tax that would theoretically decline over time, and you would also deduct the 6.2 percent, or the employee half of the payroll tax, from private accounts. Would the employer side, the employer's 6.2, remain in place as well?

Mr. KOTLIKOFF. Well, the 8 percentage point contribution could be divided 4 and 4, between employers and employees.

Mr. BENTSEN. And the 4 points would stay in place?

Mr. KOTLIKOFF. Well, yes, 4.4 would stay in place to pay for DI and SI. Those programs would stay in place.

Mr. BENTSEN. So to fund the transition is an 8 percent consumption tax?

Mr. KOTLIKOFF. We'll see some good economic news and some fiscal improvement, so in terms of the government's cash flow, it might not need to be 8 percent. We haven't actually done a serious costing out. Maybe it is 6 percent.

You may be able to get some general revenues to help pay for the transition as well.

Mr. BENTSEN. And then you talked about progressive structure. There would be a base benefit?

Mr. KOTLIKOFF. There would be a matching contribution, which would be structured on a progressive basis. So if you didn't contribute anything, there would be no matching contribution. But the government would contribute on behalf of the disabled. The government would also require people who are unemployed to contribute 8 percent of their unemployment checks to the program.

But to return to your question, if you are a low-income worker and you put in your contribution, the government is going to provide a matching contribution, which is going to be a larger percentage for you than for a high-income person.

Mr. BENTSEN. So there won't be just a base benefit. It would be—you would have the 4 percent that is paying a base disability benefit or survivor's benefit in the event that you utilize that?

Mr. KOTLIKOFF. If you become disabled, yes. I wouldn't eliminate the SSI program.

Mr. BENTSEN. And the 8 percent, your benefit then would be whatever the return is on your 8 percent at the time of retirement, converted into an annuity. So if it was—if you did well, then you get a good benefit; if you didn't do well, you——

Mr. KOTLIKOFF. Remember, everybody is going to do the same because everybody is in exactly the same portfolio, which is a global——

Mr. BENTSEN. But if it is 8 percent of $20,000 versus 8 percent of $64,000, then the cross-subsidy that occurs right now would be eliminated. Because a person with 8 percent of $64,000 would have a larger core, so they would have greater—you know.

Mr. KOTLIKOFF. Somebody earning $64,000 would get a larger Social Security benefit today than somebody earning $20,000. But the matching contribution would be a bigger deal for the low contributor under our proposal, because the match is going to phase out once your contribution gets large enough. So the first so many dollars is matched at X percent per dollar; the next so many dollars of your contribution is matched Y, where Y percent is lower than X percent.

Mr. BENTSEN. And Ms. Olsen, under the Cato—or your concept, rather, I guess—there would be no—you wouldn't get involved in this progressive match concept. It is just whatever it is, is.

Ms. OLSEN. Right. What we would do—well, first of all, when you talk about a progressive benefit structure, the whole argument is based on this idea. It depends on what your goal is for a progressive benefit structure. If it is to redistribute income, then I understand where you are coming from.

Mr. BENTSEN. Let me interrupt real quick, because that is an important thing. Is your goal rate of return, or is it a social insurance system?

Ms. OLSEN. My plan—well, the Cato plan or the Cato plans actually do both. Because there would be a Federal guaranteed safety net that you could set at the poverty level or higher, so that you could ensure that no worker ever retires in poverty, which you don't do under Social Security; in that sense, that is a social insurance plan.

In the sense that you are allowed to diversify your portfolio and get returns from the market, you are also increasing rates of return, which is also met by the plan obviously.

Can I go back really quickly to say that if your goal is to redistribute income, I understand why you want a progressive benefit structure; but if the goal of a progressive benefit structure is to ensure that nobody lives in poverty or to lift the lot of the lower-income workers, Social Security does a terrible job of that, and what will do better is to allow people to save and invest their funds, so you don't need it at that point.

Mr. BENTSEN. My time is running out, so let me ask you this.

We know that the 8 percent tax is something—maybe 7 percent, something we need to think about. But I mean, on this other plan, if it is so great, why haven't we done it other than our own ineptitude? I mean, surely somewhere there is a catch.

I don't think the market return is going to be that great. Do you assume the transition costs? An 8-percent tax is a pretty hefty transition cost, I think. Somewhere else there has to be a transition cost. Somewhere—and we discussed this last week, somewhere, somebody gets a lower benefit; and again that is something we are very concerned about at this end of the equation, because we tend to hear from those folks.

I mean, who is it? What is the transition cost? Who gets the lower benefit? Or does no one get the lower benefit, everybody gets a bigger benefit, and if so, we can sign up tomorrow.

Ms. OLSEN. The way we look at it is the way that Milton Friedman looks at it, and that is, Social Security has run up a $9 trillion unfunded liability. Now, you can either make good on that promise or you can renege.

What we are saying is that by switching to a private system that is invested, you can stop running up that debt and then you can figure out how to pay it. All you are doing is making it explicit. You are not adding any new debt, and in fact, you are reducing future debt by doing it. You can finance it any number of ways.

Mr. BENTSEN. I understand that, but my question is, how are you proposing that we finance it? Who has what share that they are having to pay? Because at the end of the day, that share is real dollars out of somebody's pocket somewhere. I think that is the key answer that, you know, politicians are going to want here.

Ms. OLSEN. The way that we would do it would be to spread the costs as much as possible. So we would issue a lot of new debt, we would cut corporate welfare and things like that. We have three or four different transition plans that I would be happy to supply you with.

Chairman SMITH. The gentleman's time has expired. Maybe we can get another short round.

Mr. Ryan.

Mr. RYAN OF WISCONSIN. Thank you, Mr. Chairman.

One of the benefits of sitting at the end of the table is, I get to hear people's names repeated many times, so I think I have it down.

Ms. Kijakazi, I wanted to go back to something you just said in your last moment of testimony, where you analyzed the Archer plan and suggested that the Archer plan would be detrimental to women and minorities, not because of its design, but because of its funding stream.

I think you were accurate in saying that our surplus streams are different. The surplus stream is very big from Social Security surpluses and that dries out in about the year 2014 and our on-budget income tax surplus stream grows. So if we are putting up a permanent funding structure for a 2 percent private account system, as you suggested, that may dip into the on-budget surplus.

Is that what you suggested? Is that correct?

Ms. KIJAKAZI. My statement was that the budget resolution envisions using the on-budget surplus——

Mr. RYAN OF WISCONSIN. When they have to be tapped?

Ms. KIJAKAZI. No, the on-budget surplus would be used for tax cuts. That leaves an amount equal to the Social Security surplus to fund the individual accounts proposed by the Archer-Shaw plan. Once that Social Security surplus is gone, then it is likely that discretionary programs will be cut to fund the individual accounts.

Mr. RYAN OF WISCONSIN. You have to have the money somewhere to pay for that. So your point that it is detrimental to women and minorities is the assumption that the monies that will be cut in the year 2015 are programs that are aimed at serving women and minorities, so it is kind of a political projection that in the year 2015, they are going to go after those programs, not other programs.

Ms. KIJAKAZI. That among the programs that would likely be cut are programs that are beneficial to women and people of color.

Mr. RYAN OF WISCONSIN. So this is not concrete, more of a speculation?

Ms. KIJAKAZI. That is right. This is one of the concerns that we have about the Archer-Shaw proposal.

Mr. RYAN OF WISCONSIN. I would like to go back to something else.

I have noticed that we have had conflicting testimony as to Social Security's treatment of women and minorities, and different reform plans, but in the current system.

I would like to ask each of the panelists to take a look at each of the panelist's testimony and talk about how your data refutes the other person's data. Because listening to the three of you, I am hearing some conflicting evidence. It sounds like there may be apples-versus-oranges types of comparisons.

I would like to readdress the issue of, now that you have had the benefit of listening to each other's testimony, is Social Security a bad deal for all people? Is it a bad deal for women? Is it a bad deal for minorities? Or is it a good deal with respect to other programs?

And under personal investment account systems, is it a better deal for these groups we are talking about?

I would like to start with you if I could.

Ms. KIJAKAZI. Thank you. I would very much like to address that point.

I think I have cited data that indicate that Social Security is a good deal for women. Women pay in 38 percent of the payroll taxes, but receive 53 percent of the benefits. African Americans receive a slightly higher rate of return than the general population.

Mr. RYAN OF WISCONSIN. Related to life expectancy issues?

Ms. KIJAKAZI. For Hispanic Americans or African Americans?

Mr. RYAN OF WISCONSIN. Both.

Ms. KIJAKAZI. For African Americans, it is because of the progressive benefit, early retirement benefits and the disability and survivors' insurance.

For Hispanic Americans, it is because of the progressive benefit, their longer life expectancy which means they receive Social Security benefits longer—with cost of living adjustments.

Now, in terms of individual accounts, what is not being said here is that when you invest, there is a chance that you will lose some or all of what you have invested. There is no mention being made of this.

Mr. RYAN OF WISCONSIN. Are those comments directed toward plans that do not have a guaranteed benefits premise or safety net put in place in those?

Ms. KIJAKAZI. Yes.

Mr. RYAN OF WISCONSIN. So they are not directed toward the plans that do have a guaranteed benefits system?

Ms. KIJAKAZI. Yes.

And I have another comment concerning the plans that do have this guaranteed system.

Mr. RYAN OF WISCONSIN. OK.

Ms. KIJAKAZI. With respect to the proposals to which Ms. Olsen has been making reference, some people will be winners. Are those winners likely to be low-wage earners? No, for several reasons. Low-wage will have smaller accounts. Women and low-wage workers tend to invest more conservatively—this is logical because they cannot afford to lose any of their money. Low-wage earners have fewer resources to purchase good investment advice. Finally, under these accounts, it is not clear that spouses, especially divorced spouses, will receive a share of the individual accounts.

Regarding earnings-sharing, a proposal that was also made by Ms. Olsen, there was a study done in 1988 by the Center for Women Policy Studies that indicated that there would be an equal number of women getting fewer benefits than they do under Social Security, as there would be people gaining from earnings sharing.

Mr. RYAN OF WISCONSIN. Since my time is running out, I would like to ask the other panelists to comment on that data that we have been hearing as well.

Mr. KOTLIKOFF. Let me just say that I think there is no chance that the system that I am proposing would deliver as bad a deal as the current system does to postwar Americans. If you look at the market's rate of return over any 30-year holding period, it has been a very big, positive number. I am talking about holding not just U.S. stocks, but global stocks and global bonds as well.

So there is just no chance really that you could get a system that is going to pay less than 2 percent, which is what the current system—well, it is really probably going to be 1 percent if we continue to go along the way we are going and have a payroll tax hike, which is going to have to happen.

If you look at table 5 of my testimony, you will see what I think is the answer to your question, Congressman, about how Social Security is treating different groups under current law. To brag just a little bit, I think this is the most extensive study of Social Security's treatment of America's workers that has ever been done, because it is the only one that has been done based on a microsimulation analysis. It takes into account all of the various benefits under OASI—survivor, mother, father, children's benefits, earnings testing, early retirement benefits, etc. We nearly bugged the Social Security actuaries to death getting all the details right.

What you find is that women do do a lot better in terms of internal rate of return than men, but even the women are earning less than the 3.9 percent you could earn buying a long-term Treasury bond protected against inflation.

You find that nonwhites do slightly worse in terms of rate of return than do men. That is a difference with Dr. Kijakazi's perspective, that nonwhites do appear to be doing worse in terms of rate of return, even taking into account the progressivity and other features of the system.

The noncollege educated do not do as well as the college educated.

The lifetime poor do a lot better than the middle class in terms of rates of return and certainly than the lifetime rich.

The basic story however is that none of these rates of return is around 4 percent, and that is what you can get in the marketplace today with perfect assurance. That is because we are locked into paying off the liabilities of the old system.

The only way we are really going to help our kids in the long run—and that means poor with the male kids, poor nonwhite kids, and poor female kids as well in the future—the only way we are really going to help them is to limit their fiscal burden and to limit the liabilities on them; and the privatization in the manner that I am proposing would certainly do that.

Chairman SMITH. Moving on to Representative Clayton.

Mrs. CLAYTON. Thank you, Mr. Chairman.

I want to thank you for having this hearing. This is an area that I care a lot about, and I am remiss that I haven't propounded my questions more thoroughly. But let me just ask—and I know I am going to have difficulty with these names; I haven't been around long enough to get the names straight.

Ms. Kijakazi, I wondered if your response that women, minorities and children were doing better in Social Security, which I believe and have been persuaded they are, is based on the fact that the safety net isn't based on the rate of return; the safety net is based on its longevity rather than its percentage of return.

Ms. KIJAKAZI. It really has to do with Social Security being a comprehensive program. Social Security is not just the retirement program from which elderly are benefiting. Social Security includes disability and survivors' benefits, as well as retirement benefits.

The study that I referred to was conducted by employees of the Treasury Department who had access to actual earnings and benefit data, so they could look at the actual rate of return received by workers. These researchers did not need to use microsimulation, which make use of estimates and case study examples in order to try to determine what the rate of return might be. The Treasury Department researchers used the actual data on workers, retirees, and survivors.

Mrs. CLAYTON. Is that based on—let me get—now, Dr. Kotlikoff just said that his proposal obviously is referring to table 5, and would enhance the return for, supposedly, female babies who will be at the age of the transition. And he is doing rate of return, and of course he bases his rate based on income, more income—you put in more, you get a better rate.

What I am persuaded to believe is that Social Security has been a safety net for those at the end of the income spectrum when there will be no other retirement. I could not participate in my husband's retirement, other than his life benefit right now. But yet if my husband dies and I survived as a spouse under Social Security, there is a commitment.

Mr. KOTLIKOFF. That is extremely important.

Under my plan you would get your survivor benefit because we do not change the survivor part of Social Security. Under my plan, you would get those benefits.

You would also have your private retirement account, which would be paid out in the form of an annuity which would continue as long as you live; and it would be indexed against inflation, just like Social Security retirement benefits.

So my plan, I think, would provide more protection for survivors.

Mrs. CLAYTON. I like the new plan, so I am trying to figure out how we would keep—the plan that I like is the one that I have the privilege of participating in with the government. It just allows you to take the max and it goes out and you can select or whatever.

But at the same time, I don't think in this plan I have, other than the fact I make a will and say where my net income will go—how does yours differ?

Ms. KIJAKAZI. If I could just jump in for a moment, one of the problems, and I haven't had a lot of time to study Dr. Kotlikoff's plan, but just in listening to him, one of the things that he does not seem to be doing is deducting the transition costs from the rate of return that he has cited. That is an incorrect way to cite his rate of return. The transition cost must be deducted before he gives the actual rate of return. The administrative costs must also be deducted from the rate of return.

Mr. KOTLIKOFF. Let me respond to that. I think our proposal is the only one that is really honest about the transition costs. We are coming out front and center saying, you need to have a way to pay off the benefits under the old system; and our plan is not doing that surreptitiously by cutting people's benefits under the old system and saying, you are going to lose so many benefits based on how you do with your private account.

We say, we are going to give you your full, accrued benefits but you are going to pay for that through a consumption tax that everybody, young and poor—well, not the poor elderly, but everybody but the poor elderly would contribute to.

So when I say that in the long run, our kids and the next generation of kids are going to get a full market rate of return, it is after that transition. So you are right that during the transition, there are some real costs, but our plan is the only one that is honest about those costs, about all of us having to pay off the old benefits through a consumption tax.

Ms. KIJAKAZI. And the transition period can be——

Mr. KOTLIKOFF. Forty-five years.

Ms. KIJAKAZI. Yes, it is a long time.

Mrs. CLAYTON. Administrative costs wouldn't be as costly as transition costs, but I gather what you are trying to make sure there is a safety net, and so your transitional cost is to make that——

Mr. KOTLIKOFF. Under my plan, there are SI, DI programs; the government is contributing to private accounts on behalf of the disabled; there is progressivity in terms of matching contributions;

there is earnings-sharing, contribution-sharing so that nonworking spouses are protected. There is lots of social protection. There is every important element that anybody who really loves Social Security thinks is essential to maintain.

Mrs. CLAYTON. How much does your plan cost? Have you estimated?

Mr. KOTLIKOFF. The real cost is that you are having a consumption tax which might be somewhere between 6 and 8 percent. The tax rate is going to decline through time. Also, bear in mind that you are eliminating a payroll tax or a component of a payroll tax and replacing it with a consumption tax.

Mrs. CLAYTON. It is a consumption tax across the board, or like a sales tax?

Mr. KOTLIKOFF. It is effectively the same as a sales tax, but again the poor elderly would be protected because they are living off of Social Security and those benefits are CPI indexed, so their real purchasing power is insulated. Suppose Steve Forbes has a birthday party and has a yacht trip, like his dad did, around New York City and spends $3 million on one party. Under our proposal he would pay a huge tax, 8 percent of that $3 million on that one party. So it is really the rich and the middle class elderly who would be asked to help younger people contribute to paying off this collective problem.

Ms. KIJAKAZI. There is one other point that I would like to address and that has to do with the disability insurance program. Funding for disability insurance is going to run out sooner than OASI. It is projected to run out in 2022.

You are saying that you would protect disability benefits, but there has to be a way of funding those benefits once the disability insurance fund runs out. Once the fund is exhausted, disability benefits would have to be reduced or taxes would have to be raised. If disability benefits are cut, then low-wage workers will be least able to afford to go out into the private sector and purchase disability insurance to make up the difference.

Chairman SMITH. I don't think Dr. Kotlikoff would agree that those benefits—just a short response.

Mr. KOTLIKOFF. I think the bottom line is we have a very major intergenerational problem here which is being obfuscated by the kind of government accounting we are doing. The real impact of the President's proposal is to lead us to think that we don't have to do anything to really get our long-run shop in order. That is really what is going on.

We are not really doing major Social Security reform, or major Medicare reform, to deal with the impending fiscal disaster that we have set up.

Chairman SMITH. We welcome to the dais Mr. Gil Gutknecht, a Congressman from Minnesota and a member of the Budget Committee.

Mr. GUTKNECHT. Thank you, Mr. Chairman.

I really haven't heard enough of the testimony to ask a particularly intelligent question except to say that I have been having hearings around my district, and I have made presentations to high school students, to college students. As a matter of fact, this weekend I made a presentation to about 150 senior citizens, and as I listened to the ending part of this testimony and some of the responses to some of the questions, I am reminded of a story that is told by one of the comics, Rodney Dangerfield.

He comes home one night and his wife is packing. And he says, Is there something wrong, dear? And she says, I am leaving. And he says, Is there another man? She looks at him and says, There must be.

When I look at where we are with Social Security, I really do think it is a matter of generational fairness or generational equity, and I think we have to be honest and say that there must be a better system than we have today, because what we are doing today is, we are literally guaranteeing, if we don't make some changes, that we are going to pass on to our kids obligations to take care of us that they will not be able to take care of.

This is fundamentally flawed. This is not—in fact, I think we have all participated to a certain degree politically. We have demagogued the issue to a sense that—we talk about the Social Security trust fund; "trust fund" has a nice sound to it. I mean it has trust and it sounds like there is a fund.

We have really been too slow to be honest with ourselves and with the American people, and particularly with our kids, that it is a pay-as-you-go system, OK? And long-term—you know, I was born in 1951, there were more kids born in 1951 than any other year. I am the peak of the baby boomers.

So we have to come up with a whole new system. We have to figure out a way to create some generational fairness. I don't know how you do that without somehow incorporating a way to get better than 1.9 percent real rates of return on the money.

And so I am not certain what the perfect answer is, and I am delighted that we have real experts. I am going to look forward to looking through the testimony and particularly some of the charts and studies, because it seems to me we need to bring together some of the best minds in the United States.

We need to be honest, we need to look at the problem, and I think over the next year or so, perhaps we can come up with a better solution than we have today. Because today what we have on the table, it seems to me, is a prescription for disaster. It is a little like the Y2K problem. We know it is coming; we know about when it is going to start to really become a serious problem, and we have been given, by the grace of God, about 11 or 12 years to come up with a solution. But we need to make that solution now.

So I don't really have a question, but I appreciate these hearings, and I have taken more time than I should.

Mr. RYAN OF WISCONSIN. Will the gentleman yield?

Mr. GUTKNECHT. I think it is important that since this is a hearing that is on the record that we talk about and reveal the actual numbers and statistics with respect to debt reduction that have been achieved with the various different plans we have talked about. I know we have been talking about the President's plan. I think it is important to note that the budget resolution that this committee passed, and passed in the House and the Senate, achieved $450 billion in additional debt reduction than the President's plan does, and that, in fact, the President's plan leaves us with a resulting budget debt, debt held by the public, or debt subject to the debt limit of $8.6 trillion.

So it is important to note these things as we take a look at how these different plans affect the national debt.

Chairman SMITH. A quick round and we will try to finish up in the next 5 or 10 minutes.

I am going to direct this to you, Ms. Olsen. Since you haven't said much yet, give us a couple of reactions to what has been said.

Ms. OLSEN. One of the questions that I did want to address is the women's question. And, Mr. Ryan, I think what you said was "apples and oranges," and in a way it is. There is a favoritism toward women because of the progressive benefit structure, but in absolute dollar terms their benefits are lower. So you could say they are favored, but you could also say they do worse than men. Both of those statements are accurate.

What Larry said was exactly the point that I wanted to make about that, which is that no matter how you slice it, whether women are—whether there is a progressive benefit structure or not, whether they do worse or better than men, everybody is getting such a raw deal from this system. At best, you are getting a 2 percent return, most young workers are going to get a negative return, and when you could just invest in Treasury bonds and get a 4 percent return, it begins to look worse and worse. So I think that that is very important.

Also, in my paper, I wanted to address this idea about the low-income workers. There is a myth out there that Social Security protects women from poverty and protects low-income people from poverty. That could not be further from the truth. Thirty percent of African-American women in our country live in poverty while collecting their Social Security benefits. If they could take 12.4 percent of their income or 10 percent of their income or even 5 percent of their income and invest it, they could retire well above the poverty level, and that is the truth. That is what needs to come out today.

Chairman SMITH. All right. I would just like to point out in acknowledging those considerations what I did in my Social Security bill 4 years ago and 2 years ago. I included two aspects that helped deal with that problem. One is, I increased survivor benefits from the 100 percent of the higher benefit rate to 110 percent of the higher benefit rate. Secondly, I took the lead from Dr. Kotlikoff in terms of a unified investment opportunity so both the man and the wife have their eligible investment opportunity together, and divided by two so you do away with the attorneys during a divorce settlement.

So I think that was an excellent idea. Dr. Kotlikoff, what do you call it?

Mr. KOTLIKOFF. Contribution sharing.

Chairman SMITH. Contribution sharing, sold. And you, Ms. Olsen, also suggested the wisdom of something like that.

Ms. OLSEN. Yes, I do. We call it earnings-sharing. There are a number of—we are actually going to be doing a paper on it, some technical details, I think June O'Neill might be doing it for us. But it is a definitely a good idea, an easy way to protect spouses who do not work, and also to protect people in a divorce so that nobody runs off with the entire pool of retirement funds.

Mr. BENTSEN. In Texas we call it community property. Fortunately, I have never had experience with that, and I don't want to, even though the statistics read differently.

I am glad to hear my colleague from Wisconsin talking about debt retirement. As he may recall, I offered the amendment in the committee that would have done more debt retirement than anybody, but it failed.

And I would also caution him, as he knows as a newer Member and former staff, that the budget resolution is one thing, but the final law will determine whether we pay down any debt or not.

Mr. RYAN OF WISCONSIN. Mr. Chairman, I would like to credit the gentleman. If your amendment had passed, it would have achieved the most amount of debt reduction per any plan being offered here in Congress. So I wanted to acknowledge that.

Mr. BENTSEN. I appreciate that.

Let me ask very quickly just a couple of questions. Ms. Olsen, the Shirley and Spiegler plan, if I understand it, does it assume that 5 percent of the 12.2 percent is transferred to a private account, and then there is a mandatory supplemental contribution of 5 percent?

Ms. OLSEN. Well, they did it several different ways. They did 5 percent with a guarantee, and they also did 7 percent and they also did 10 percent.

Mr. BENTSEN. In your packet it talks about 10 percent, that is, 10 percent—that is, 12.2—12.4 minus 5, plus 5. Is that how they get there? Because they retain 7 percent for a two-thirds flat benefit.

Ms. OLSEN. Not in the 10 percent plan. The 10 percentage points is a full privatization plan that takes 10 percentage points of the 12.4. The 5 percent does have a flat benefit, and that is not in the small paper that I attached; that is in the larger study.

Mr. BENTSEN. It says here under the fully private system, the assumed contribution rate is 10 percent.

Ms. OLSEN. Right, and it does not have a flat——

Mr. BENTSEN. Oh, OK, I see.

Does it assume transition costs?

Ms. OLSEN. They did not do transition costs. You had asked that question earlier and somebody had said, well, you have to deduct the transition costs from the rate of return. The transition costs is a cost that has been run up by the Social Security system, so I don't think that you necessarily have to—I don't think it is fair to say that you would deduct it from the rates of return.

Mr. BENTSEN. Let me tell you why I think that is important, very quickly, and for all three of you. We were just talking about debt and we talked about IOUs and we talked about whether a trust fund is a trust fund.

If you go look in the law, the trust fund is a trust fund under the law. I am sure somebody could try and weasel their way out of it. I like paying down debt; before I was in Congress, I liked issuing debt because I was an investment banker. I also believe in the sanctity of debt and the contract that goes with it.

The fact is, you can't design these plans and not have a way to pay for them and then go back and say, well, we are going to make up for that later. All of these plans and the problem we are in now may be because we have run up debt or the associated debt too much. But you have to look at the whole picture.

I would say the same for Dr. Kotlikoff, that the 8 percent ultimately at the end of the day will affect your return on investment. It may not directly, but indirectly it will. And I question even the argument that while Malcolm Forbes or Steve Forbes may pay $240,000 for having this boat trip around Manhattan—the elderly, because they are getting a CPI adjustment, is going to be some of it; because I doubt that the CPI adjustment will make up completely an 8 percent consumption tax, particularly when they—at the lower end they will be consuming more of their disposable income at the upper end.

Mr. KOTLIKOFF. Let me respond to that.

The elderly would be fully insulated. The rich and middle-class elderly would be hurt relative to the current system which is not sustainable. Current workers would be somewhat better off because they would be rid of an 8 percent payroll tax, although they would have to pay a consumption tax. Overall and given the consumption tax is going to be declining through time, they would be better off than under the current system.

So we are not disguising the fact that there are burdens to be paid, the transition burdens. We are up front, we are honest about that.

Mr. BENTSEN. And I appreciate that.

Mr. KOTLIKOFF. In the long run, the rate of return that people will be able to get will be the full market rate of return. That is in the long run; that is not during the transition. People will be able to get the full rate of return on their private accounts, but there is this additional transition cost.

Mr. BENTSEN. And you don't think an 8 percent tax, a corporate tax, might have an impact on earnings that could affect stock price and an ultimate rush on investment?

Mr. KOTLIKOFF. Another thing that needs to be brought out in this hearing, which hasn't come out, are the macroeconomic impacts of privatizing Social Security. I developed a model with an economist who is at Berkeley named Alan Auerbach. Our model is being used at the CBO as, I believe, their primary model for simulating tax reform and Social Security's privatization.

If you simulate transitions under which you actually pay off the liabilities of the old system, for example with a consumption tax, you actually have a positive kick to the economy in terms of saving. In the short run, you depress somewhat consumption as a share of national output, so you get a higher saving rate. You also get more capital accumulation and higher real wages, and this helps the poor. Whether they are nonwhites, whether they are women, regardless, it helps them in the long run.

When you try and engage in a shell game, which is what you are concerned about, basically just borrow more money to put it into a trust fund, and you don't really deal with this generational imbalance in a substantive way, you end up with a worse economy in the long run.

So sweating the transition is incredibly important and the consumption tax is the way to finance a transition in terms of getting the best bang for the buck with respect to economic performance.

Mr. BENTSEN. Thank you.

Ms. OLSEN. Can I just follow up? I believe it was Alan Greenspan who said that the markets have taken into account the unfunded liability. So I don't think that it is necessarily correct for you to say that payroll—that the rate of return would necessarily have to go down in financing the transition.

I don't think that that is necessarily—just let me finish, please. I don't think that that is necessarily accurate. I think it is debatable.

Finally, we don't ignore the transition; it is just that in certain studies you have to focus. But we have published four different plans, ways of financing the transition, and as I said before, I would be happy to get those to you.

Mr. BENTSEN. I just want to make sure that when you are doing this—I mean, transition will have some impact on—whether it is a sales tax or a consumption tax or whatever, it has to have some impact. It is not coming out of a different pot of money. All the money, as Cato well knows, comes from the same taxpayers, so it somewhere has an impact.

Chairman SMITH. I think that is such an excellent point, because we can talk all we want to about how we are going to divide up whatever pie exists 20, 30, 40, 50 years from now, but part of the question is, how do we get a bigger pie so that whatever slice is coming out is bigger. If we are going to end up under the current system with two workers trying to earn and produce enough stuff, as one of my friends puts it, to satisfy their family needs plus one retiree, how are we going to make sure we have the kind of economy where we increase our productivity and our research.

And so growth and higher savings and investment has to be part of our goal.

So specifically, Dr. Kotlikoff, have you looked at the problems of the intergenerational transfer in terms of that effect? And you can talk about the other, too, but what about just specifically the considerations of the intergenerational transfer of transferring wealth from the young to the old and the effect on our economic growth?

Mr. KOTLIKOFF. Well, the basic story is that if you privatize Social Security, you are going to have some impacts. You are going to have to burden on current generations. But in burdening those current generations, you lower their consumption, and thus you increase national saving, increase capital formation, you increase the tools that workers have to work with and therefore, you make the economy bigger and more productive.

In our simulations we find out that per capita output is about 15 percent higher after the transition than at the beginning. That is not enormous, but 15 percent is pretty good. The capital stock is about 40 percent larger.

The alternative, I want to stress, is just to continue muddling along and end up 20 years from now with payroll tax rates which will be 20 to 25 percent to pay for this program. Bear in mind, we already have an economy in which virtually every citizen is paying at the margin about 50 cents on the dollar to State and Federal Governments in different kinds of taxes.

If we add another 10 or 20 percentage points on for a rate that, we are talking about serious problems, about people who do not want to be in the formal sector, about an erosion of the tax base, about a Brazil in terms of the fiscal situation. We are also talking about printing money to pay for our bills. That is the alternative to doing something sensible like we propose.

Chairman SMITH. A wrap-up for Dr. Kijakazi, if you would like about a minute for a wrap-up or comments, and also Ms. Olsen.

Ms. KIJAKAZI. I would like to address the last point that you made about how to improve the economy, how to increase the money coming into the trust fund.

Individual accounts are not what increases the rate of return to Social Security; it is advance funding. If one of the goals is to increase the rate of return, you do not have to achieve this through individual accounts; you can accomplish this by investing part of the trust fund in equities. Investing the trust fund will increase the rate of return to Social Security without incurring the administrative costs, transition cost, or risks of individual accounts.

One of the proposals in the Clinton plan is to invest a portion of the trust fund in equities using a broad market index. A politically and fiscally independent board set up like the Reserve Board and the Thrift Investment Board that serves the Thrift Savings Plan would oversee the investment. Increasing the income to the trust fund will reduce the amount by which you would have to cut benefits or raise taxes in the future without putting the individual at risk.

Chairman SMITH. Ms. Olsen.

Ms. OLSEN. Thanks for the chance to wrap up.

Just in conclusion I would like to go back to the message that I started with, which is that it doesn't really matter if men are doing a little better than women or women are doing a little better than men, or African Americans are doing a little bit better than Caucasians under this system.

The point is that nobody in this system has a good deal: The best returns you are looking at are 2 percent; young people are getting negative returns; and this is a system that is now $9 trillion in debt. If we do nothing, we have—we are looking at benefit cuts of 30 percent or a tax increase to almost 20 cents on the dollar.

So this is a system that even though it may favor some or disfavor others, is not a good deal for workers. We know that there is something much better, and that is a system that is based on individually owned accounts that can be saved and invested, that are prefunded for the future. That is what we need, and that is what you should consider as you go forward in trying to think about how we are going to have a real secure retirement system in the 21st century.

Chairman SMITH. Thank you all very much for giving up your time to testify before the committee today. I would like to announce that next week, Tuesday at 12 o'clock, Dr. Roger Ibbotson and Dr. Gary Burtless are going to be here to testify on the long-run investments in terms of what those long-term investments can do as far as having a positive effect on Social Security.

With that, thank you all again, and the Task Force on Social Security of the Budget Committee is adjourned.

[Whereupon, at 1:45 p.m., the Task Force was adjourned.]

Using Long-Term Market Strategies for Social Security

TUESDAY, MAY 11, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12:10 p.m in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Members present: Representatives Smith, Herger, Ryan, Rivers, and Clayton.

Also Present: Representative Spratt.

Mr. SMITH. The Budget Committee Task Force on Social Security will come to order.

We have two expert witnesses today to pass on some of their advice and estimates on the advantages of using investment as part of our total solution to Social Security. Social Security's unfunded liability that ranges in estimates from $4 trillion to $9 trillion can be solved in three ways, it seems to me. We can cut benefits, we can increase taxes, or we can get a better return on some of the investment that individual workers in this country are making.

The current Social Security program gives the average worker a 1.8 percent return on their payroll taxes today. In contrast, corporate stocks have given investors an average of 11.2 percent return, measured from 1926 until 1998. Opponents of the investment strategies for Social Security are quick to point out that stock prices go up and down.

This volatility should not prevent us from considering the benefits of higher investment returns to provide greater retirement income to all American workers. Over time, the ups and downs of the stock markets have always, if you will, balanced out on the upside, and investors have learned that they can count on higher returns for funds that can be invested for the long run. Since many workers pay Social Security taxes for 40 years or more, they can use this long-term investment strategy and the magic of compound interest to retire much wealthier than they might otherwise.

This investment strategy, I think, requires that a portion of the Social Security taxes have some of the advantages of capital investment. That is the purpose of our hearing today.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Social Security's $9 trillion funding gap can be closed in only three ways:

- Cut benefits
- Raise taxes
- Increase the rate of return earned on workers' contributions

The current Social Security program gives the average worker a 1.8 percent investment return on their payroll taxes. In contrast, corporate stocks have given investors average annual rates of return up to 11.2 percent, measured from 1926 to 1998. Opponents of investment strategies for Social Security are quick to point out that stock prices go up and down.

This volatility should not prevent us from considering the benefits of higher investment returns to provide greater retirement income to all American workers. Over time, the ups and downs of the stock market balance out, and investors have learned that they can count on higher returns for funds that can be invested for the long run. Since many workers pay Social Security taxes for forty years or more, they can use long-term investment strategies with confidence.

This investment strategy requires that a portion of Social Security be placed into pre-funded accounts and invested. This fundamental change to the pay-as-you-go structure should be considered as a means of strengthening Social Security for the long run.

Would you like, Ms. Rivers, to make any introductory comments?

I'll introduce witnesses today. Dr. Burtless is a Senior Fellow in Economic Studies with the Brookings Institution. Dr. Burtless has published various articles on Social Security, Medicare and social welfare, and testified before several House and Senate committees. He has published various articles and presented testimony.

Gary, I am sorry I didn't bring one of your articles or books to hold up, but I did bring one of Dr. Roger Ibbotson's books, and this is the annual condensation of what is happening in stocks and bonds and bills and inflation. It is a book that must sell very well, because every financial and asset manager has several in their offices.

So thank you, Dr. Ibbotson, for being here today.

Dr. Ibbotson is a Professor of Finance at Yale University's School of Management, and also serves as Chairman of Ibbotson Associates, which publishes the annual yearbook. He has been recognized as a leading expert in measuring rates of return for the last 20 years.

In 1974, during one of the worst bear markets in U.S. history, Dr. Ibbotson predicted that the Dow would reach 10,000 by 2000. He apparently underestimated that to some extent, since we are already there. He is now expecting to see the Dow 100,000 by the year 2025.

Let's start with each of you making an introductory statement of approximately 5 or 6 minutes. So, if each of you would make an opening statement of 5, 6, 7 minutes, and then we will open up for questions.

STATEMENT OF GARY BURTLESS, SENIOR FELLOW, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. BURTLESS. I defer to the finance expert, Dr. Ibbotson, on issues connected to financial history.

My interest in this subject comes from my interest in Social Security and social welfare protection. Return on investment has become an important issue in thinking about how this kind of insurance and social protection can be made available to people.

There is a lot of interest right now in replacing part or perhaps even all of the Social Security retirement protection with a system of individual retirement accounts. Mr. Chairman, I heard you say at the beginning you compared a rate of return under Social Security of 1.8 percent, which is, I think, approximately what people retiring today can expect to receive on their contributions and those of their employers, with 11.2 percent, which was the average rate of return on common stocks in the United States since 1926.

I think that we have to think about some differences between these two numbers. One is that 1.8 percent represents a real rate of return, the rate of return after adjusting for the difference in prices between when you put your contribution in and when you make withdrawals in the form of pension benefits. Eleven-point-2 percent, in contrast, is a nominal rate of return. The real rate of return since 1926 has been closer to 7 percent, and going back to 1871, it has been closer to about 6.3 percent. So if you compare like to like, the real return in Social Security with a real return in common stocks, it is a difference of 1.8 percent versus 6.5 or 7 percent.

But there is another difference too, and the other difference is that 1.8 percent represents a return that is backed by the power of the government to tax wage-earners, and so it is a very secure rate of return. There is less uncertainty over what it is going to be.

The 6.5 percent or 7 percent return that we have seen over various historical periods on common stocks has fluctuated widely over time. If you look at the picture at the back of my testimony, labeled figure 1, it shows the historical pattern of 15-year average annual returns on stock market investments. At the end of 15 years, you calculate what you would have, adjusting for difference in prices, if you had invested $1 15 years earlier, and then calculate the average annual return. Figure 1 shows that there has been an enormous range since 1871 in the 15-year trailing real rate of return. It has averaged 6.3 percent, but there have been six periods when the rate of return over 15 years was negative; and there have been eight 15-year periods in which it has exceeded 15 percent. So there is a very wide variation.

I also heard you say, Mr. Chairman, that over time, if you have a long enough period for investment, these wide fluctuations even out, and that is true. But the fluctuations don't completely disappear. The purpose of my calculations in this testimony is to show how much variation there is left if workers had 40-year careers in which they invest a certain percentage of their pay in stocks, and then live on the nest egg that they have accumulated when they retire.

Chart 3 calculates annuity payments. It shows the situation of a worker who contributes 2 percent of his pay into stocks and constantly reinvests all the dividends in stocks, and then converts whatever the nest egg is at the end of a 40-year career at age 62 into a level annuity. The chart shows how much that annuity is going to be as a share of that worker's peak career earnings.

Mr. SMITH. Again, if he invests 2 percent of his taxable payroll; is that what you are saying?

Mr. BURTLESS. Yes, yes.

Mr. SMITH. OK. Go ahead.

Mr. BURTLESS. Obviously you would come up with other numbers if you invest a different percentage of the worker's pay. You can see that the low point of annuities was the annuity for someone retiring in 1920. That annuity would have replaced about 7.5 percent or so of his peak pay. At the high point in annuities (in the mid-1960s) the annuity would have replaced 40 percent of peak earnings. So there is a huge difference in the value of the annuity people could obtain under this kind of a system. Chart 4 shows how the real rate of return—the internal rate of return measured when people turn 62—how much that return varied. This rate of return varied from a low of 2 percent for people retiring in 1920, up to a high of about 10 percent for people retiring in 1965.

There is one other risk that workers face that private individual retirement accounts have not protected them against, and that is inflation after they retire. Chart 5 shows the historical effects of inflation on four workers. In particular, it shows the replacement rate if, instead of measuring it at the date that they retire, we look at replacement rates at successive ages after retirement. So you can see for people retiring in 1965, they started out with a very high pension, 40 percent of their peak pay, but by the time they were 80, they were only receiving an annuity equal to about 12.5 percent of their peak earnings. That is because inflation had eroded the value of their pension.

Thus, even though it is true that the real rate of return we can expect on common stocks is reasonably high, there still is a lot of variability in the living standard that workers can afford if they consistently invest in stocks and then try to convert their savings into an annuity when they reach retirement age.

[The prepared statement of Mr. Burtless follows:]

PREPARED STATEMENT OF GARY BURTLESS, SENIOR FELLOW, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Congress and the public are rightly concerned about the future of Social Security. Many people have proposed novel and dramatic reforms to the system to assure its solvency or improve workers' rate of return on their contributions. One popular proposal is to establish a new system of individual, privately managed retirement accounts that could be invested in high-return private securities, such as common stocks. This approach can push up workers' returns in the long run. But this can only occur if we increase the level of reserves that back up future pension promises. In other words, our retirement system must move away from pay-as-you-go financing and toward greater advance funding. This in turn requires that some Americans accept a temporary reduction in consumption, either by making larger contributions to the pension system or accepting smaller pensions.

Individual accounts have no inherent economic advantages over the alternative proposal to accumulate a larger reserve in the existing Social Security system. There are some political advantages to accumulating additional reserves in individual accounts, but there are efficiency advantages to accumulating reserves in a single collective account, such as the OASI Trust Fund. Accumulating private assets under either approach entails financial market risks. In one case the risks are borne collectively by the government (and ultimately by all taxpayers and pension recipients). Under a system of individual accounts, in contrast, the financial market risks would be borne by individual contributors and pensioners.

Since the basic goal of a government mandated pension system is to ensure workers a predictable and decent income in old age, the reform plan we ultimately adopt should be one in which the collective, defined-benefit plan provides the bulk of mandatory pensions, especially for workers with average and below-average lifetime wages. A single collective fund exposes these contributors to far less financial risk than an alternative system in which most of their retirement income is derived from individual investment accounts.

RISKS AND RETURNS OF INDIVIDUAL ACCOUNTS

Many critics of Social Security want to scale back the present defined-benefit plan and replace it partially or fully with a privately managed system of individual defined-contribution pension accounts. Such accounts could be run independently of traditional Social Security or as an additional element in the existing system. Advocates of individual accounts claim three big advantages from establishing individual accounts:

- It can lift the rate of return workers earn on their retirement contributions
- It can boost national saving and future economic growth
- It has practical political advantages in comparison with reforms in existing public programs that rely on higher payroll taxes or a bigger accumulation of public pension reserves

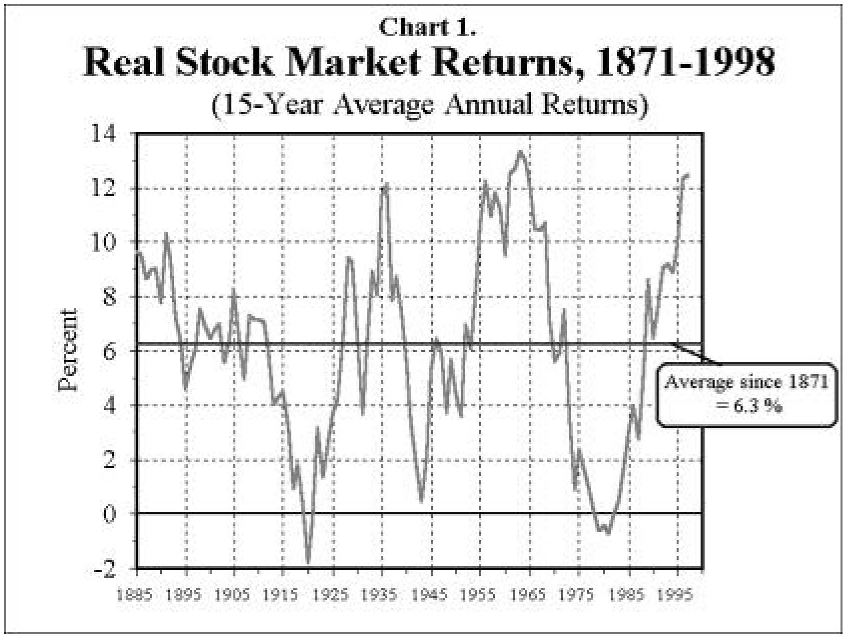
Individual account plans differ from traditional Social Security in an important way. The worker's ultimate retirement benefit depends solely on the size of the worker's contributions and the success of the worker's investment plan. Workers who make bigger contributions get bigger pensions; workers whose investments earn better returns receive larger pensions than workers who invest poorly.

The most commonly mentioned advantage of individual accounts is that they would permit workers to earn a much better rate of return than they are likely to achieve on their contributions to traditional Social Security. I have heard it claimed, for example, that workers will earn less than 0 percent real returns on their contributions to Social Security, while they could earn 8 percent to 10 percent on their contributions to an individual retirement account if it is invested in the U.S. stock market.

This comparison is incorrect and seriously misleading. First, the claimed return on Social Security contributions is too low. Some contributors will earn negative returns on their Social Security contributions, but on average future returns are expected to be between 1 percent and 1½ percent, even if taxes are increased and benefits reduced to restore long-term solvency.

Second, workers will not have an opportunity to earn the stock market rate of return on all of their retirement contributions, even if Congress establishes an individual account system in the near future. As noted above, workers' overall rate of return on their contributions to the retirement system will be an average of the return obtained on their contributions to individual accounts and the return earned on their contributions to whatever remains of the traditional Social Security system. For most current workers, this overall rate of return will be much closer to the current return on Social Security contributions than it is to 8 percent.

Investment risk. Advocates of individual retirement accounts often overlook the investment risk inherent in these kinds of accounts. All financial market investments are subject to risk. Their returns, measured in constant, inflation-adjusted dollars, are not guaranteed. Over long periods of time, investments in the U.S. stock market have outperformed all other types of domestic U.S. financial investments, including Treasury bills, long-term Treasury bonds, and highly rated corporate bonds. But stock market returns are highly variable from 1 year to the next. In fact, they are substantially more variable over short periods of time than are the returns on safer assets, like U.S. Treasury bills. Chart 1 shows the pattern of real stock market returns over the period back through 1871. I have calculated the 15-year trailing real rate of return for periods ending in 1885, 1886, and all other years through 1998. The return is calculated by assuming that $1,000 is invested in the composite stock index defined by Standard and Poor's and quarterly dividends are promptly reinvested in the composite stock. The 15-year trailing return has ranged between −2 percent and 13 percent since 1885. The historical real stock market return averaged about 6.3 percent.



Some people mistakenly believe the annual ups and downs in stock market returns average out over time, assuring even the unluckiest investor of a high return if he or she invests steadily over a 20-year period. A moment's reflection shows that this cannot be true. From January 1973 to January 1975 the Standard and Poor's composite stock market index fell 50 percent after adjusting for changes in the U.S. price level. The value of stock certificates purchased in 1972 and earlier years lost half their value in 24 months. For a worker who planned on retiring in 1975, the drop in stock market prices between 1973 and 1975 would have required a drastic reduction in consumption plans if the worker's sole source of retirement income depended on stock market investments.

We can evaluate the financial market risks facing contributors to individual retirement accounts by considering the hypothetical pensions such workers would have obtained between 1910 and 1997. The 88 hypothetical contributors are assumed to have careers that last 40 years, beginning at age 22 and ending at age 62. When contributors reach age 62 they cease working and convert their accumulated retirement savings into a level annuity. To make the calculations comparable across time, all contributors are assumed to have an identical career path of earnings and to face the same mortality risks when they reach age 62. Contributors differ in the path of stock market returns, bond interest rates, and price inflation over their careers and retirement. These differences occur because of the differing start and end dates of the workers' careers.

The results of this exercise can be summarized briefly. Even though workers on average obtain good pensions under individual retirement accounts, there is wide variability in outcomes. Assuming workers deposit 2 percent of their annual pay into a retirement account that is invested in common stocks, historical experience suggests their initial pensions can range from about 7 percent of their peak career earnings to 40 percent of their peak earnings. While most workers would welcome the opportunity to earn better returns on their contribution to the retirement system, defined-contribution accounts would expose workers to a substantial hazard that their pensions would be too small to finance a comfortable retirement. When we consider the effects of inflation on the value of annuities after workers retire, the financial market risks associated with individual accounts seem even bigger.

Details of the calculations. I have made calculations of the pensions that workers could expect under an individual account plan using information about annual stock market performance, interest rates, and inflation dating back to 1871.[1] I start with the assumption that workers enter the workforce at age 22 and work for 40 years until reaching their 62nd birthdays. I also assume they contribute 2 percent of their wages each year to their individual retirement accounts. Workers' earnings typically rise throughout their careers until they reach their late 40's or early 50's, and then wages begin to fall. I assume that the age profile of earnings in a given year matches the age profile of earnings for American men in 1995 (as reported by the Census Bureau using tabulations from the March 1996 Current Population Survey). In addition, I assume that average earnings in the economy as a whole grow 1 percent a year.

While it would be interesting to see how workers' pensions would vary if we altered the percentage of contributions invested in different assets, in my calculations I assume that all contributions are invested in stocks represented in the Standard and Poor's composite stock index. Quarterly dividends from a worker's stock holdings are immediately invested in stocks, too. Optimistically, I assume that workers incur no expenses buying, selling, trading, or holding stocks. (The average mutual fund that holds a broadly diversified stock portfolio annually charges shareholders a little more than 1 percent of assets under management. Even the most efficient funds impose charges equivalent to 0.2 percent of assets under management.) When workers reach their 62nd birthdays they use their stock accumulations to purchase a single-life annuity for males. (Joint survivor annuities for a worker and spouse would be about one-fifth lower.) To determine the annuity company's charge for the annuity, I use the Social Security Actuary's projected life table for males reaching age 65 in 1995. To earn a secure return on its investments, the annuity company is assumed to invest in long-term U.S. government bonds. The nominal interest rate on these bonds is shown in Chart 2. I assume that the annuity company sells a "fair" annuity: It does not earn a profit, incur administrative or selling costs, or impose extra charges to protect itself against the risk of adverse selection in its customer pool. (These assumptions are all unrealistic. Annuity companies typically charge an amount that is between 10 percent and 15 percent of the selling price of annuities to cover these items.) My assumptions therefore yield an overly optimistic estimate of the pension that each worker would receive.

[1] Stock market data are taken from Robert J. Shiller, *Market Volatility* (Cambridge, MA: MIT Press, 1989), Chapter 26, with the data updated by Shiller. Inflation estimates are based on January producer price index data from 1871 through 1913 and January CPI–U data from 1913 through the present. Bond interest rates are derived using 1924 through 1997 estimates of the average long-bond yield for U.S. Treasury debt; yield estimates before 1924 are based on yields of high-grade railroad bonds.

Chart 2.
"Riskless" Long-term Interest Rate, 1910 - 1997*

Note: "Riskless" rate is assumed equal to nominal U.S. Treasury long-bond rate from 1924-1997 and equal to adjusted high-quality railroad bond rate 1910-1923 (see text).

Chart 3 shows the replacement rate for workers retiring at the end of successive years from 1910 through 1997. The hypothetical experiences of 88 workers are reflected in this table. The worker who entered the workforce in 1871 and retired at the end of 1910, for example, would have accumulated enough savings in his individual retirement account to buy an annuity that replaced 19 percent of his peak lifetime earnings (that is, his average annual earnings between ages 54 and 58). The worker who entered the workforce in 1958 and retired at the end of 1997 could purchase an annuity that replaced 35 percent of his peak earnings. The highest replacement rate (40 percent) was obtained by the worker who entered the workforce in 1926 and retired at the end of 1965. The lowest (7 percent) was obtained by the worker who entered work in 1881 and retired in 1920. Nine-tenths of the replacement rates shown in the chart fall in the range between 10 percent and 37 percent. The average replacement rate was 20.7 percent. (For workers retiring after 1945 the replacement rate averaged 25.3 percent.)

Chart 3.

Male Single-life Annuity as a Percent of Career High Annual Earnings (Measured at Age 62)

Note: "Replacement rate" is the worker's intial annuity divided by his average real annual earnings when he was 54 - 58 years old.

Chart 4 shows the real internal rate of return on the contributions made by the 88 workers. This return is measured at age 62, when the worker retires. Since 1910, when the first worker retired, the real internal rate of return ranged between 2 percent and almost 10 percent. The average rate of return was 6.4 percent.

Chart 4.

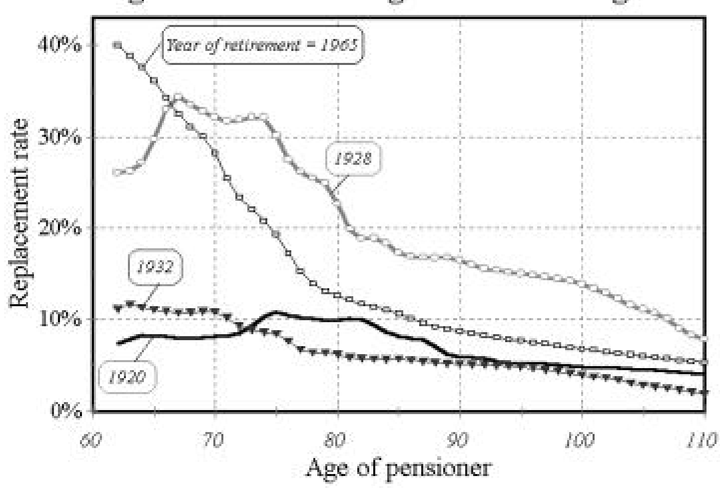
Internal Rate of Return Measured at Age 62, 1910 - 1997

Note: Arithmetic average internal rate of return, 1910 - 1997, is 6.4 %; minimum return is 1.7 %; maximum return is 9.9 %. Arithmetic mean return for careers that began after 1925 is 7.2%.

The principal lesson to be drawn from these calculations is that defined-contribution retirement accounts offer an uncertain basis for planning one's retirement. Workers fortunate enough to retire when financial markets are strong obtain big pensions; workers with the misfortune to retire when markets are weak can be left with little to retire on. The biggest pension shown in Chart 3 is more than 5 times larger than the smallest one. Even in the period since the start of the Kennedy Administration, the experiences of retiring workers would have differed widely. The biggest pension was 2.4 times the size of the smallest one. In the 6 years from 1968 to 1974 the replacement rate fell 22 percentage points, plunging from 39 percent to 17 percent. In the 3 years from 1994 to 1997 it jumped 14 percentage points, rising from 21 percent to 35 percent. Social Security pensions have been far more predictable and have varied within a much narrower range. For that reason, traditional Social Security provides a much more solid basis for retirement planning and a much more reliable foundation for a publicly mandated basic pension.

The calculations in Charts 3 and 4 ignore the effects of inflation on the value of workers' annuities after they retire. Workers typically cannot buy annuities that are indexed to the price level, as Social Security pensions are indexed. Chart 5 shows how the real replacement rate varied over workers' retirements for four workers whose retirements began in 1920, 1928, 1932, and 1965. For workers who retired before World War II, prices did not always rise; in some periods, they fell. A worker receiving a level annuity receives a windfall when prices decline. The value of his annuity rises. But rising prices rather than falling prices have been the norm since the end of the Great Depression. A worker who began receiving a $100 monthly pension in 1965, for example, would have received a pension worth just $70 by the time he was 70 and just $31 by the time he was 80. The steep decline in the value of this worker's pension is shown in Chart 5 with the line labeled "Year of retirement = 1965."

Chart 5.
Real Annuity as Percent of Career High Annual Earnings at Selected Ages



On average, inflation has reduced the rate of return workers would actually have obtained on their individual-account pensions. Chart 6 shows the trend in rates of return on worker contributions, when the rate of return is calculated at the age of death of workers rather than at age 62, when they first begin collecting pensions. Notice that the average realized rate of return is 1.2 percentage points lower than the rate of return calculated at age 62. This simply reflects the fact that, on average, workers would have received real annuities that are less in value than was anticipated when they first began their retirements.

Chart 6.
Internal Rate of Return Measured at End of Life, 1910-1997

Note: Average internal rate of return through through end of life is 5.2%; minimum return is 2.1%; maximum return is 7.6%. Arithmetic mean return for careers that began after 1925 is 6.0%.

CONCLUSION

The debate about reforming Social Security should not rest on exaggerated claims about the potential gains workers can obtain from a shift to privately managed individual retirement accounts. Social Security provides workers with crucial protections against financial market risks. It is worth remembering that when the system was established in 1935, many industrial and trade union pension plans had collapsed as a result of the 1929 stock market crash and the Great Depression, leaving workers with no dependable source of income in old age. The private savings of many households was wiped out as well. Given these circumstances, most voters thought a public pension plan, backed by the taxing power of the Federal Government, was preferable to sole reliance on individual retirement plans.

Financial market fluctuations continue to make private retirement incomes uncertain. Workers who invest in financial market assets, such as common stocks, bonds, and annuities, are exposed to three kinds of risks: The risk that asset prices will decline around the time workers begin to retire; The risk that annuities will be expensive to buy when the worker must convert his retirement nest egg into a level annuity; And the risk that price inflation during the worker's retirement will seriously erode the value of his annuity. The existence of these kinds of risk means that there is a continuing and crucial role for traditional Social Security, even in the case of workers who earn middle-class wages throughout their careers.

Mr. SMITH. Dr. Ibbotson.

STATEMENT OF ROGER IBBOTSON, PROFESSOR OF FINANCE, YALE UNIVERSITY SCHOOL OF MANAGEMENT

Mr. IBBOTSON. Yes, I am an expert in investments, let me say, and I have some knowledge about Social Security issues, and I want to actually talk about both subjects here, although I am sure I will be mostly talking about investments.

Starting out with the Social Security problem. The basic problem is that this has been—is now, and always has been primarily a pay-as-you-go system, so that current workers are paying the benefits of current retirees, and the problem we are in that I guess probably everybody here recognizes is that the changing demographics are changing the mix of workers to retirees. We are having far more retirees per worker than we did in the past.

Social Security also—and I just want to bring this up front—seems to serve another purpose here, and many of us have views on this. Social Security performs somewhat of a wealth-transfer system because I—maybe it makes some attempts, but I think partially by design the system is not in balance. The individual account, if you were taking individual contributions, they do not match what the individual would get in retirement.

The system has various biases. The most obvious is the young—favors the young over the old, but it also favors women over men because women live longer. At low wages, low-wage earners over high-wage earners because it smooths things out, and there are a lot of other imbalances.

Now, I am saying these are—we have opinions about what we want Social Security to do, but it is only a partial retirement system and it is also partially a wealth-transfer system.

In terms of getting it on a reasonable footing—I think Chairman Smith pointed it out—the three items right off the bat, you either have to reduce benefits in some way, increase savings, or increase returns on investments. I actually believe that we have to really do some of the first two of those, however painful they may be to the American people, that we may have to actually reduce some benefits that may be in the form of, say, delaying the age when you first get benefits or restricting who is eligible or taxing benefits in some form. I think that the benefit level cannot be sustained without substantial increases in savings rates.

Savings rates can come in many different forms too. They can come in the form of higher payroll taxes, of course, but they might be—and I am sure we will talk about it today—privatized savings accounts, or perhaps applying general budget surpluses to make up part of this shortfall.

What I will try to focus on here mostly, though, is the third item, getting a higher return on investments, because obviously that is not painful unless we actually suffer some of the risks associated with that higher return. But we all would like to get higher returns where most of us here would be reluctant to have higher payroll taxes or higher savings accounts and reduced benefits.

I actually think, though, we have to do all three, so I am not suggesting that there is a magic bullet in higher returns; it can only be a partial solution.

Generally, though, before we could even talk about getting returns, higher returns, we have to talk about making an investment, because that requires some prefunding. We have the Social Security trust, but it has only limited prefunding. The funding is not even close to the potential liabilities here, and I have heard lots of numbers. I haven't done any calculations, but they have been up to $10 trillion in liabilities, and the funding is nowhere near to that extent. But with some funding, then we can have investment.

Now, I have to warn everybody again, unfortunately, that we have the pay-as-you-go system, we have the current benefits. We have to really pay the benefits and make the prefunding in some sort of a pretty long transition period, where to think of a—you have to pay for your parents' benefits at the same time you are making investments into your own retirement plans. So you sort of have to do both here, and that is why straightening this whole process out is likely to be painful.

But in terms of what to invest in, let me make a simple statement, and that is stocks do out-return bonds over the long run. They have historically—most of my measures go back to 1926, but we can go back further, if necessary. But going back to 1926, stocks have returned 11.2 percent per year. At the same time, U.S. Government bonds have returned 5.3 percent. So there is about a 6 percent differential between stocks and bonds. That 6 percent differential has actually a dramatic effect over time because of the compounding. If you put money away and let it run over 30, 40, 50, 70 years, 73 years in this case, this is amazing. A dollar at 11.2 percent over 73 years grew to $2,351. And $1 in bonds at that 5.3 percent grew to $44, a much lower amount.

Now, it is true that this includes inflation, and the inflator is about 9, if you divide those numbers by 9; or if you want to rough it out, divide by 10, still, even dividing by 10, a dollar in real terms in the stock market grew to $235. That is 73 years; that is really in our lifetimes there, what—maybe it is a little longer than our working lives, but it is the kind of result that you can get from these high returns if they are realized.

The $44, as the $1 grew in bonds, I guess if you divide that by 9, that is about 5, a little less than five times your money, not that much growth over the long run. Basically you are covering inflation.

Now, as Dr. Burtless has pointed out, stocks have risk, more risk than bonds; that is true. And there has been—over this period starting in 1926, there has been a period as long as 20 years starting in the Depression, starting in 1929 where bonds out-returned stocks, so it is possible to have a long period of time where bonds do better than stocks.

There has been the worst case—if we go back to the Depression, stocks lost from their highs in 1929 to their lows in 1932—they lost 80 percent of their value. So there definitely is a potential downside to this. Yet, over the long run, stocks do outperform bonds. Forty-seven out of the 73 years, stocks had a higher return than bonds, so about two-thirds of the time, the return on stocks is higher than the return on bonds.

Over a long horizon, looking forward, the odds are high that stocks will outperform bonds. The longer the horizon, the higher the odds that stocks would outperform bonds. Stocks actually—since 1926, they have never had a negative 20-year period, and they have only had—if you take all the overlapping 10-year periods which is 64 10-year periods that overlap, only two of them were negative. So the odds of being negative over a 10-year period are quite low and not very high at all for—we have never had one over a 20-year period. So I think that over the long run, the odds are extremely high that stocks will outperform bonds.

I will say, though, that—and I guess we, the American people and you in Congress on this committee and so forth, have to make this kind of a judgment. There are risks in the stock market. I know that the U.S. Government sort of acts as a safety net to the

U.S. economy, and when times are at their worst, perhaps the government will be there for us. So we recognize that we are concerned about these risks and still, I believe that the trade-offs are sufficient here. The odds are high, if we can be long-term investors, that is the key. If we can be long-term investors, the odds are very good that stocks will do better than bonds. So generally I would advocate at least some investment in the stock market.

Of course, this is very different—I will handle this in questions, I am sure, but it is very different whether this is part of a public fund which is doing the investing or whether these are privatized accounts.

Thank you.

Mr. SMITH. Thank you.

[The prepared statement of Mr. Ibbotson follows:]

PREPARED STATEMENT OF ROGER G. IBBOTSON, PROFESSOR OF FINANCE, YALE UNIVERSITY SCHOOL OF MANAGEMENT

Chairman Smith and distinguished members of the House Budget Committee's Task Force on Social Security.

I am an expert on the long-term investment returns of stock and bond markets. I am generally familiar with the Social Security structure and issues.

THE PROBLEM

The basic problem is that the current system is and has always been primarily a pay-as-you-go retirement system. Current payroll OASI taxes are used to pay retirement benefits of current retirees. The system is mostly unfunded, and to the extent it is funded, it is used to hold and offset U.S. Government debt.

The pay-as-you-go system cannot work indefinitely, given the changing demographics of our workforce, with ever larger proportions of the population being retired.

Also, the Social Security system, partially by design and partially by its very nature, has not paid out individual benefits that are aligned with that same individual's contributions. In general, the system favors the old over the young, women over men, low wage earners over higher wage earners, along with numerous other imbalances. Thus the system works as a welfare wealth transfer system, as well as a retirement system.

SOLUTION POSSIBILITIES

There are only three possibilities: Increased savings, reduced future retirement benefits, or higher return on investment.

1. *Increased Saving Rates.* Any reasonable plan has to increase savings rates. This can come in the form of higher payroll taxes, private savings accounts, or merely applying projected government surpluses to help solve the problem.

2. *Reduced Retirement Benefits.* These can be reduced by delaying the age of first benefits, reducing the amount, restricting eligibility, etc.

3. *Higher Return on Investment.* Assuming there is a least some prefunding, the sums could be invested in higher returning assets. The current surpluses are used to offset government debt. Alternatively, they could partially be invested in common stocks, which might be expected to produce higher returns.

PREFUNDING

In order to earn returns on investment, the investment has to be prefunded. This is true whether the system continues to be run entirely by the U.S. Government, or whether it is to be partially privatized. Prefunding requires a transition stage from the pay-as-you-go system. During this transition, extra investment must be made, since the current benefits still have to be paid.

STOCK RETURNS VS. BONDS RETURNS

Stocks usually outperform bonds. Since 1926, common stocks returned 11.2 percent per year, while U.S. Government bonds returned 5.3 percent per year. One dollar invested 73 years ago in common stocks grew to $2,351 versus only $44 in bonds.

Over the long run, investing in higher risk assets can have a substantial impact on accumulated wealth. I expect the historical payoffs for risk to continue in the future over the long run.

THE RISK OF THE STOCK MARKET

Stocks are riskier than bonds. There has been as long as a 20 year period in which bonds outperformed stocks. In our worst historical case, stocks lost over 80 percent of their value from their 1929 high to their 1932 low. Yet stocks outperformed bonds almost two-thirds of the years (47 out of 73). Over longer horizons, the odds increase that stocks will outperform bonds. U.S. Stocks have never had a negative return over a twenty year period, and only in 2 of 64 overlapping 10 year periods.

The U.S. Government often acts as a safety net to the U.S. economy. Stocks will likely perform worst when the economy is at its worst. Although the long horizon risk is relatively low, is it acceptable to us? If the system is partially privatized, individual investors will make their own risk and return trade-offs. Experience shows that most people are willing to invest at least some of their retirement funds in the stock market.

I favor investing only a small portion of our Social Security funds in the stock market. This provides diversification, without creating undue risk.

Mr. SMITH. One of the questions certainly is, are individuals capable of investing their own money? I just relate my experience at a company called Spartan Motors in Michigan. I was touring the factory and went into the lunch room and there were three workers over there, sweaty and obviously line workers. One had tattoos and another had a pony tail. What they were reading in the lunch room is the Wall Street Journal. And I asked the CEO, well, gosh, that is pretty impressive. And he said well, since we started revenue-sharing in our 401(k) program, the three of them over there will average having a stock market investment of over $100,000 apiece, and they have really started studying and asking questions.

So one question is, how do we take advantage of the up-market, if it is going to go up, and how do we minimize the disadvantages of some of the stocks that are going to go down?

But maybe a specific question for both of you is, Dr. Ibbotson, why do you think we will see the Dow at $100,000 by 2025? And the question to you, Dr. Burtless, is, do you think he is underestimating this time as he did in 1974, or do you think he is overestimating?

We will start with you, Dr. Ibbotson.

Mr. IBBOTSON. Well, let me say that that is pretty much the same forecast that I made in 1974. You take the bond yield, you add the premium of how stocks outperform bonds on average over it, and you project it forward. I did that back in 1975; actually, this was after a very poor period in the market and everybody thought I was very optimistic. But I made that forecast, essentially adding about 6 percent return above and beyond the bond return to the stock return, and projected it forward—and the Dow does back out the dividends to get the number because the Dow doesn't include dividends. But just projecting that forward, it is about 10 percent, it took the Dow—at that time the Dow was in the 800's, it took the Dow to 10,000 at the end of the century. We got there a little early.

I am making a similar forecast when I take the Dow to 10,000 to 100,000 over the next 25 years, that we would get about a 6 percent return above and beyond what government bonds would pay; and I am saying, though, that this happens not without risk. In fact, I actually forecast these as probably distributions, not certain that you get this, but that is the median, middle forecast of what I would predict.

Mr. SMITH. Dr. Burtless, additionally, do you think he is high or low? I think I hear you saying from your testimony that you do support capital investment. The question is, how do you minimize individual risk?

Mr. BURTLESS. Right. But I hate to get in the business of forecasting what the stock market is going to do, because I think it is inherently very difficult to predict. My guess is that it is also very likely that stocks will continue to outperform bonds, although I would say in the next 10 or 15 years, the degree of difference between stock and bond returns may be lower just because the valuation of stocks is currently so high. Also, interestingly enough, the real yield that people are obtaining on U.S. Treasury bonds is also higher than its historical norm. So the difference, I think, at least in the next 10 or 15 years, is likely to be smaller than it has been historically.

I think that it does make sense to try to use this third option you mentioned in your introductory remarks to try to improve the return on worker contributions as much as we can. I agree with what my academic colleague here says, that it will be necessary to either increase contributions or reduce benefits, but to the degree that we can get a better return on whatever reserves we hold, that would lessen the need to reduce benefits or increase taxes.

And I definitely think that there is a way to do it and minimize risk to individual workers, and the simple way is for the Social Security trust fund to manage the investment in stocks.

Mr. SMITH. This means we have 1-minute to go for my time. Explain how individual workers could minimize risk if we had personal retirement savings accounts?

Mr. IBBOTSON. There are various ways individuals could do it. I know there are some proposals on the table. Generally, though, I would think we would want to make it easy for individuals because I don't think—I don't think we would want individuals given the total freedom to buy Internet stocks every day, buy and sell them, but to get them into more or less, maybe a few options of one mix or another, maybe an aggressive or conservative and a moderate mix where they are preset for them, and perhaps we would use index funds, although we wouldn't have to have index funds.

But I would say that it is potentially achievable for individuals to do this, and I haven't advocated necessarily to do this, because I think it is very dependent on what system you come up with here, whether I would be in favor of it or not. But generally individuals do manage their money in 401(k) accounts, they manage their money in accounts; they learn to manage their money. I recognize that we want to make this available to such a wide group of people that there is some period of time when they have to learn how to do this. So I think we have to make the options simple for them at the start.

Mr. SMITH. Representative Lynn Rivers, my esteemed colleague from the great State of Michigan.

Ms. RIVERS. Thank you, Mr. Chairman.

Thank you, gentlemen. I have a question first for Dr. Burtless.

The kind of annuity that people discuss in the context of Social Security either doesn't seem to exist or doesn't seem to exist in any great number out there, which is some sort of annuity that is going to exist for the life of the person, which is unknown, of course, at age 65.

Do these kinds of annuities exist? Would it be possible for someone to craft something based on a private account that is going to not just not be eroded by inflation, but is going to last for as long as they live, say they live 30 years after retirement. We had someone here from the Human Genome project telling us that people are theoretically capable of living until 130 years old.

Mr. BURTLESS. It has long been possible for people to get an annuity for as long as they live. It has not been possible for people to get an annuity that is indexed to the price level in the United States. I have been told by Peter Diamond, a Professor at MIT, that one of his graduate students discovered a small insurance company in Ohio that is offering indexed annuities, that is, annuities indexed to prices. However, the company was unwilling to say what the price was they would charge for an indexed annuity, so it is hard to take that into account when I perform my calculations.

In principle now, it is possible for an insurance company to offer indexed annuities, because the Federal Government offers indexed bonds. If the company's portfolio consisted of indexed bonds, then it could always be sure that it would have enough money in the account to make the promised annuity payments.

Ms. RIVERS. The indeterminate-length annuity, how would that differ from one for a set period of time?

Mr. BURTLESS. Oh, insurance companies already offer that vehicle. You can buy one. Because the insurance companies have an expected life span that they use, they can offer annuities that last until death. For every 1,000 people that come in to buy the annuity, they have a pretty good idea for those 1,000 people what the distribution of required payments will be. So they are able to offer pretty secure unindexed annuities right now; and they have been able to offer that kind of a plan for a number of years.

Ms. RIVERS. OK.

Dr. Ibbotson, I have a couple of questions for you. One is, in talking about the issue of prefunding—and we have heard people speak to that before here, and it is a considerable amount of money that would be necessary to prefund the existing Social Security system. It seems it would be pretty costly to prefund the new system, and you recognized that by saying, somewhere along the line we have to get extra investment.

Most of the witnesses that we have had here—I don't want to say "all," because I don't remember, but most of the witnesses here have suggested that for any sort of transition, the general fund surplus that is projected is going to be inadequate. Where else would you go for the cash to fund a transition?

Mr. IBBOTSON. Well, I haven't done any calculations, whether it would be inadequate or not, and I am not fully aware of the full surplus plan over all of these years, although I listened to President Clinton's speech, State of the Union address.

Let me say, I would imagine that we would perhaps partially fund and do this over a long span of time. I have no magic source of extra money. It could come in the form of some payroll piece that is set aside in some way; it could come from additional surpluses, but it ultimately has to come out of our pockets in some way. There is no way to—I have no secret pile of money here under the desk that I can bring forward here.

Ms. RIVERS. All right.

The other question that comes up a lot when we are considering investments, and I know we have been talking about averages, and I know that generally the argument is that the stock market yields a high return, and virtually—some investors do have—how would you inoculate people from the effects of those losses on their retirement, or would you?

Mr. IBBOTSON. Well, if it is totally privatized like IRAs, people have had their losses and they have made their choices, and I think they have to suffer them. One way, though, to restrict the losses is to enforce some diversification so that individuals, say in a privatized plan, have only a limited number of choices. They can't just invest in anything. That would enforce diversification on them.

I will say, though, that once we are in the stock market, we can never insure these losses, or once we totally insure it, we have given away the extra gain. So although I could devise plans and give advice to people to reduce their risk, there is no way we could eliminate the risk.

Ms. RIVERS. The other concern that I have, which is a different kind of risk, is administrative costs that people would be charged for doing investing; or when such a huge number of people go into the investment market that you have sort of Herb's Investment Service springing up on every corner.

What would be the best way to help people move into a direct investing system?

Mr. IBBOTSON. I think that the administrative costs could be high—I think over time they would be driven down, but we would have a variety of competition arising. However, I would imagine that if you are starting out with this, that we have some sort of a system where the government is setting up some sort of pool of accounts which have low administrative costs. They would be perhaps—if we are talking about privatized accounts, they would be in individuals' names and they could have different asset indexes, but the accounts would be pooled.

To the extent that the government is doing the investing, I would certainly recommend that they be indexed, because I would really be worried about—in spite of how highly I think of everybody here in the government, I would be worried about all of the political pressures involved in trying to invest money. I would think that if the government is actually making the investments that they be invested in as broad of an index as possible and have it be removed as much as possible from the political process.

Ms. RIVERS. Are we going to have a second round, Mr. Chairman?

Mr. SMITH. Yes.

Ms. RIVERS. OK. I will come back to Dr. Burtless in the second round.

Mr. SMITH. I might say that the Thrift Savings Account managers, Mr. Burtless, who charge two basis points would know something about the complexity of setting up something and taking bids.

Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Dr. Burtless, I think I hear you expressing a concern that so many of us have, and I have two parents myself who are 80-plus, and that concern is, it would be nice if we—I don't want to put words in your mouth, but just to paraphrase what I think I hear a lot from others, it would be nice to have an investment that was making the type of return that we have seen averaged over the last several decades—number of decades. However, what happens if we go into a 1930's scenario where we get into a downturn, and it is not there for them? And I think this is a valid concern.

My question would be, what would be your feeling if we say we are able to, as the Federal Government, as the U.S. Congress and the President, come up with an agreement where we could guarantee the safety net of a minimum of what we are paying out now in Social Security, but somehow we were able to, maybe through a tax return which many of us are looking at, turn back to the taxpayers in the form of so much percent beyond that, but something in addition that would be invested; and then we guarantee them a minimum of this safety net, but still allow a couple percent, or whatever it might be, that is being invested into the market and hopefully in as safe a manner as we are able to do.

How would you feel about that?

Mr. BURTLESS. I think that there are two issues that come up with respect to a system like that. The first thing is, if you provide a guarantee to depositors, we have a situation that is not unlike the savings and loan slow-motion disaster we saw in the late 1980's. Depositors had a guarantee, if they put their money in savings and loans associations. The owners of the savings and loans were looking at a situation where if they invested in a very reckless manner, potentially they could make a lot of money, but if the investment came out bad, well, the depositors would be bailed out by the Federal Treasury, which is, in fact, what happened.

And you do have to worry a little that people will choose very risky alternatives unless there is some provision like Professor Ibbotson just mentioned in which you restrict the nature of the investments they can make. But if you restrict the nature of the investments they can make, as Representatives Archer and Shaw have proposed to do, you have lost one of the major advantages of individual accounts. As I understand the Archer-Shaw proposal, everyone has to invest in a portfolio that is 60 percent stocks and 40 percent bonds. Well, under this plan people don't get to choose the amount of risk they are going to face. What is the remaining advantage to them of being given this option to invest?

Now, it is certainly true that it is practical to offer a guarantee if you told people exactly how to invest, but then you kind of wonder, well, why are you offering this option when you could easily have the Federal Government invest 60 percent in stocks and 40 percent in bonds, and you would vastly reduce the administrative costs.

So there are two crucial issues: administrative costs, I think, and then if you let people invest in whatever they want, some people will be induced to invest very risky if they are given a guarantee.

Mr. HERGER. Well, just to continue with the question, let's say we don't let them invest anyway they want; we do have parameters. Now let me maybe move to something similar, to the type of investment that Federal employees have where you do have some kind of a choice there. But anyway, there are parameters there.

Let's say we set something up like that which would be in addition to the Social Security that we are guaranteeing. I mean, we can't be—it would seem to me we can't be any worse off than we already are, because basically part of what you described is what we already have.

But the second part, if we were to put parameters—and I certainly agree with you, if we just left it open to do as we did with the savings and loans, where you just go and put your money in the riskiest with the highest chance of return—but if you had at least some guidelines there, would that not be far superior to what we have now?

Mr. BURTLESS. If you do have individual accounts and they amount to only a small percentage of the payroll and there is still the basic traditional Social Security pension (or perhaps a slightly scaled-back pension) then if it is a small enough contribution that you are asking people to make, I don't see a reason to offer a guarantee. The guarantee in this system is still the traditional Social Security pension, perhaps scaled back some. Then people must indeed accept the risks that go along with investing a small monthly amount in their own individual retirement account.

The government should not guarantee people against losses in what is, after all, a small portion of their contribution to the system.

Mr. HERGER. But again, maybe you missed what I am asking. But the thought is that we would, at least for now, at least for the next decade or so and perhaps somewhat longer, continue with what we are doing now. This money is coming in—I mean the same type of arrangements we have now, which basically the Federal Government is standing good that we are going to pay retirees so much. But in addition to that, we have a couple percent that we begin investing so that the point is to get away from the insecurity, because that is what I hear the criticism is. Those who are criticizing this are saying well, gee, you know, we don't know, we might lose out.

So it would seem to me we have our cake and we are able to eat it too if we are, during these times of the economy going so well, that we have a golden opportunity to perhaps, if we take it, to do both. Isn't that far superior to what we are doing now, and that is, doing nothing?

Mr. BURTLESS. Well, at the moment, the government as a whole has a big surplus. I think it is out of the big surplus that people are thinking, either directly or indirectly, of financing those small accounts that you just mentioned.

Mr. HERGER. Right.

Mr. BURTLESS. And if they really are small accounts, then forcing people to accept the risk that comes with the choice that they have made, while still giving them some choice between a really safe investment vehicle like bonds and perhaps 100 percent being invested in an index fund for all of the stock market, you have given them a choice amongst several basic risk-and-return opportunities. You then simply tell them, "This is a small portion of your retirement income; it is not all of it; we still offer a guarantee for the basic Social Security pension; you accept the risk that goes along with your small individual account.

Mr. SMITH. Representative Clayton.

Mrs. CLAYTON. Thank you, Mr. Chairman.

Have either of you run a model where it shows the cost-benefit of moving from—you just, in response to the last question, you said a person putting a small amount of the Social Security would assume the risk. Have you run a model on that one?

Mr. BURTLESS. I have not run models——

Mrs. CLAYTON. On any of these?

Mr. BURTLESS. The only calculations I have performed have simply reflected the kind of pensions workers would have obtained if they had been faced with the actual investment environment that stocks and bonds have offered to investors since about 1871. So I just make calculations for 88 different workers. The first worker starts work in 1871 and he has a career and then he retires at the end of 1910. The second worker starts working in 1872, and he has a 40-year career, and then he retires in 1911. And so on.

So I have looked at the outcomes for 88 different workers, and each worker followed the same retirement investment strategy throughout his career. The results of those calculations are at the back end of the handout I distributed.

Mrs. CLAYTON. OK. I guess I haven't had a chance to read that. But the result of that, would those calculations give you the assurance that the benefit for that investment would outweigh any of those vulnerabilities in that period of time, overcome the costs of management?

Mr. BURTLESS. Well, there is a simple thing to bear in mind. In very short periods of time if you invest either in stocks or in bonds, there are sometimes big changes in the prices that you get if you try to sell these assets. When the interest rate goes up, for example, the value of bonds goes down very quickly. And sometimes, as you heard Professor Ibbotson say, stocks have fallen in price by 80 percent in the space of 3 years. Even as recently as 1974–1975 there were very dramatic reductions in the value of stock prices.

So when people have their investment savings placed in these kind of assets, in pretty short periods of time, if they are entirely invested just in one kind of asset, they can face very drastic reductions in the amount that they can afford to live on when they retire. That is simply a fair description of financial markets in the United States.

Mrs. CLAYTON. So the time you invest would remove the vulnerability of this kind of fluctuation when it is a short period of time? With the stocks and bonds, you expect that kind of fluctuation; is that correct?

Mr. BURTLESS. As I understand what you just said, the longer that you are invested in stocks (that is, the longer is the career in which you have placed money in the stock market), the less the volatility. If you look at 3-year periods, you can lose 80 percent on your investment. I mean, there have been instances where people could lose 80 percent of their money in just 3 years.

Investment losses that large have never happened for 15-year periods. If you stretch out the investment horizon to 40 years, I think there has been no 40-year period since we have had a stock market in the United States in which people would have lost money. Probably the lowest return for any 40-year period that I know of is 2 percent. A 2 percent positive real return is the lowest stock market return we have ever had over a 40-year period.

I do not predict that the future is going to be like the past. Maybe in the future real returns may dip to less than 2 percent. Still, the fact of the matter is, even over 40-year careers, there are major differences in how well people come off. Long-term returns depend critically on when they start their investment and when they retire. They also depend on interest rates at the time workers convert those investment funds into something to live on in their retirement.

Mrs. CLAYTON. I was reminded of a show they had on ABC, the Delaney Sisters, who come from my State and their father, the father of the twins admonished them years ago to give 10 percent to the Lord and 10 percent to savings. They didn't say how much they had given to the Lord, but they said 10 percent she invested over a period—after all, she lived to 101, so I guess their life experience would bear out your testimony that they invested, so they did pretty well on their investments.

Dr. Ibbotson, did I misunderstand you? You feel the value of investing beyond the individual accounts, whether the government should invest, is that——

Mr. IBBOTSON. I actually haven't personally taken a position.

Mrs. CLAYTON. Let's assume you did take a position; how would you account for the government's gap in financing the baby boomers, and assuming you were in a position to invest the so-called "surplus" that we have, and assuming that the budget resolution we just passed—Mr. Chairman, we didn't do the tax break, so we won't have that?

Mr. SMITH. All the Social Security surplus is set aside.

Mrs. CLAYTON. So the Social Security surplus we set aside into an investment pool, how then will we take care of the gap for the baby boomers who are coming due, say, by 2017 or 2013, or whatever year it is, if we have this money set aside and just—Dr. Burtless' testimony of long-term investment is the way you get the money, if you can't spend the money twice or you can't spend it for current obligations and also earn investments. So what will we do with that scenario?

Mr. IBBOTSON. Yes, we can't spend the money twice. I think you put it very well. We have to first get some investment—put some investment away, which I am recommending that once you put it away, if you invest at least some of it in the stock market, you would likely have higher returns than if you put all of it in the bond market as we currently do.

But you are still saying, how do we put some money away to start with. Well, I actually believe—I guess I am not running for office so I can say this—but I actually believe that we have to cut benefits in some way, because as we get this larger and larger group of retirees and smaller and smaller group of workers, that certainly one of the aspects of this is some form of cutting benefits.

Mrs. CLAYTON. Which benefits would you cut—spousal, disability, children, which one?

Mr. IBBOTSON. You want me to name names here. I guess, since I am not running for office, I can say that.

I won't name anybody's spouse or anything, but I will say that I think that there are wealthier people who don't rely as much on Social Security, so perhaps those benefits could be cut, for the people over a certain income or something like that, or taxed in some way or something. I think there are groups of people, various groups that we could begin cutting benefits.

I think, though, possibly across the board, we could cut everybody's benefit by not fully inflating it as we currently do, so that there is a gradual cutting of these benefits. I am certainly—that is to say, I certainly wouldn't say this at a political rally, but maybe it is being public, but I am not running for office so I can say these things.

Mrs. CLAYTON. You can change your mind and run for office later, so be careful.

Mr. SMITH. Mrs. Clayton, with your permission, we will do a second round.

I guess I would like to follow up on ways that we might look at to minimize the risk of a down market at the time of retirement. Could we make some kind of a phased transition from capital investments to bond investments? Could we gradually say that part of the savings could be annuitized the first year versus outyears?

Both of your suggestions—assuming that you were faced with these kinds of personal retirement savings accounts and looking at ways that we might minimize the risk of a down market at the time that somebody might turn retirement age.

Mr. IBBOTSON. I would like to answer that, if I may. I think there are a lot of things we can do to mitigate this risk. We can, as you said, smooth out—we don't have to buy an annuity when you are 65; we could buy some of the annuity early and some of it later, and smooth it out over some period of time to reduce the risk of that annuity. In the investment accounts, presumably these would be set up in very diversified ways.

A lot of the scenarios we are looking at are all stock investments, and I don't think we are really advocating 100 percent stock investments here. These sound like terrible cases of losing 80 percent of your money. But in a diversified portfolio, you don't get anything like those kinds of losses over that worst 3-year period in history.

So I think there is diversification, perhaps running index funds, perhaps smooth over the annuities when the annuities are purchased. There are a variety of things that will reduce this risk. They won't eliminate it, but they can definitely reduce the risk and make this palatable.

Mr. SMITH. Dr. Burtless.

Mr. BURTLESS. The reason that I invest in stocks, the primary reason is simply because they offer good returns adjusted for risk. I think that in many public discussions of alternatives to Social Security, a common number that I hear—and it comes from Professor Ibbotson's calculations—is that stocks return 11.2 percent or 11.5 percent; and Social Security returns 2 percent or 1 percent. It is important to bear in mind what those two numbers mean. There is only one way that you get a rate of return of 7 percent, which is the real (inflation-adjusted) rate of return that we have seen in the United States since 1926 in common stocks. The only way you get that is to accept the risk that comes with stock investments.

To the degree that you shift funds out of stocks into assets that reduce the variability of your portfolio, you are accepting a lower return. You know, that is the point of finance, to teach you how you select the allocation in which your trade-off for risk and return yields greatest satisfaction. You don't get 7 percent average returns if you mix your investments across both stocks and bonds.

Mr. IBBOTSON. I agree with that. I want to say one other thing just to get these numbers straight.

The 11.2 percent return on stock markets—I think the comparison is with the bond market return, which historically has been 5.3 percent; it is not—the 1 percent number that we are talking about is, yes, it is after inflation, but they are also different participants because we don't—what we put in is not what we get out because of the imbalances of the system. Different participants and different, I guess, age brackets and so forth get different amounts out, and that is not just the investment return, that is somebody who puts in their money today, what their investment is, but that is presuming that part of your money is going to pay somebody else's benefits.

Mr. SMITH. A question on if there were individual investment accounts where individuals had some flexibility on where to invest their money and how to diversify.

Are the American workers intelligent enough, concerned about their investment enough that somehow they would learn, or industry and businesses would come in to help teach individuals how to properly invest to minimize risk and maximize gain?

Mr. BURTLESS. Let me answer. I think there are three answers.

First of all, I think it is fair to say that Americans are capable of handling their own investments. It is also fair to say that their abilities and their tastes for risks differ tremendously. And it is also important to point out the findings of the empirical studies of how people make the choice between different kinds of investments when they are offered just a few, as 401(k)s typically offer.

Women are less tolerant of risk than men are. In other words, they tend to put their money in safe investments like guaranteed income contracts. Older workers are less tolerant of risk, which makes sense, than younger workers. And low-income workers are less tolerant of risk than high-income workers, meaning that they would probably obtain a lower return, although with lower risk.

Mr. SMITH. Dr. Ibbotson.

Mr. IBBOTSON. I think all of those empirical results are correct, and I think it makes sense. It is all right for some people to be less risk-tolerant than others and to have portfolios that take less risk.

You want to match the risk preferences to the people if it is a privately-based plan.

Mr. SMITH. Is there any evaluation anyplace, any studies that look at IRAs, 401(k)s, in terms of the effort of those individuals to better familiarize themselves with investment information?

Mr. BURTLESS. Yes. The Employee Benefit Research Institute conducted analyses of the effect it makes if employers have good information campaigns. I think that there are differences across employers in how risky and how sensible the distribution of 401(k) investment choices made by their employees is. So the firms that spend more to help their workers learn have workers who appear to be making better judgments.

Mr. SMITH. Representative Rivers.

Ms. RIVERS. Thank you. Some people are talking about privatized accounts, are talking about what I call the live-free-or-die model, which is a purely privatized system where people take their risks, take the consequences of their risks, and some people do very well and some people don't, and the government stays out of it. Most of the people we have heard from in here are talking about something less than that.

As I listen to both of you, we are talking about finding a way to insulate losses to some extent, rather than accepting the individual variability that might come from big losses for some people, big gains for others. We are talking about directing investment distribution, so much in stocks, so much in bonds. We are talking about limiting investment choices so that people don't have too high a taste for risk.

So I am left with, why would we go to an individualized, privatized system? Is it purely ideological? If the government is going to protect to some extent against loss, is going to direct what the load of investments will be, and is going to direct the kinds of things that can be invested in, if all we are looking for is a higher return, why go to an individualized system as opposed to just letting the Social Security Administration invest funds?

Dr. Ibbotson.

Mr. IBBOTSON. Well, I think that some individuals want to make these decisions, and they want to have control over their lives; and some of them want to take on more risk, some of them want to take on less risk. We don't want to leave it parameter-free.

Ms. RIVERS. But you favor the government limiting many of those choices, right?

Mr. IBBOTSON. Yes, but still, even with limited choices, people like to make choices, and we generally believe, I think, in this country, in allowing people to make choices where it is reasonable. And so I don't think it is purely ideological; I think there are benefits of making a choice. It does work with IRAs and other 401(k) accounts. It can be successful, and I think over time people get better at these sorts of things, too.

Ms. RIVERS. Dr. Burtless.

Mr. BURTLESS. I think one reason we have a Social Security system is the fact that in the 1930's the private retirement system failed so conspicuously for such a large proportion of the aged population. The other reason we have it is the view, both among workers and voters, that maybe individually we are not completely to be trusted in saving for our own retirement. We think that having a system in which money is withheld from us automatically and then given to us when we reach retirement age has real advantages for us. We see this in unionized companies. Almost all unionized companies have pension plans. Those pension plans take away from workers the ability to choose for themselves how much of their current pay should be invested for retirement and how much should be available right now. One reality is that the retirement system exists because we don't completely trust people to make all of these choices.

I agree with Professor Ibbotson, though, to the degree that we do need some choice. Many people think it is good to let people make their own decisions regarding the risk they are willing to absorb and the return that that will yield them.

But I think that there is a second political reality. I have sat on a couple of panels; I have had debates with people who are very much in favor of individual accounts. I think the second reality is that there are many people who just do not trust public decisionmakers to allocate the investment funds. They don't trust the government to select stocks, to buy corporate bonds, or to make real estate investments. And they don't trust public officials to vote the shares if they did own corporate stocks.

So there is a view that it is preferable to let 144 million individual Americans accumulate small retirement investments in private accounts and then leave it up to Fidelity or Barclay's or Vanguard to decide how to vote the shares in those accounts. That is politically the safest thing to do.

I do not agree with this view. I have a fundamental disagreement with it. The Federal Reserve Board's retirement plan and the Thrift Plan covering Federal employees have shown that it is perfectly possible to make apolitical decisions about how to invest retirement funds. So I fundamentally disagree with the critics of public control over the retirement investments. I do recognize, however, that there are many people whose views I respect who do not trust public decisionmakers to make investment decisions.

Ms. RIVERS. Let me ask both of you about a very political decision. That is, right now, within the political system, there is a bias on the return for low-income people. They do better under the system than higher-income people do. If we create a privatized system or a somewhat privatized system where people are investing a percentage of wages, we are going to see people who already have money doing much better than people who are in low-income positions. Frankly, I looked at poverty figures last night, which suggest that the number of working poor are growing all over the country.

Should we have some sort of way to address this in the Social Security system, or should we let—I don't want to say "let," that is not the right word. Should we ignore the increasing gap that the investing will create between the haves and the have-nots in our country?

Mr. IBBOTSON. I think what you are saying is that the higher-wage investors are willing to take more risks.

Ms. RIVERS. Well, they are investing more, so they are getting more back.

Mr. IBBOTSON. They invest more, they take more risk, they end up with more, and I am sure that is likely to be true, given choices here, that they would be the ones more likely to be taking the risk.

I think that—I said at the outset that Social Security plays a welfare function as well as a retirement function, and I think it would be difficult for me to say, let's get rid of that welfare function. I think that there are reasons to have this safety net for the American people, and so I think it is—any movement to privatize is only going to be a partial movement. Certainly the system would be largely in place and would still, it seems to me, take on these welfare characteristics.

Ms. RIVERS. Dr. Burtless.

Mr. BURTLESS. I am very much in favor of the attempted redistribution in the Social Security system in favor of low-lifetime-earnings workers. There is a real question about whether, in fact, the formula is redistributive enough if you account for the difference in longevity amongst higher-wage and lower-wage workers. I don't really know the answer to that question.

I suspect that the system is still redistributive in favor of low-wage workers. That is a feature of the system I very much favor, because I think you can look at that as wealth transfer, but it is also a form of insurance.

When you are 20 years old, and beginning to make contributions to Social Security, you don't know whether you are going to be one of the lucky workers who earns high wages throughout their careers. You may be completely confident that you are, but bad luck could dog your steps before you reach retirement, and then you very much welcome the fact that the system is redistributive in favor of people like you.

Mr. IBBOTSON. I want to say some of these redistributions might be reasonable that we want to redistribute from high wage to low wage, but do we really want to distribute from young to old, because when the young become old, then we don't have the money to do it for them, the same way that we don't for the current older generation.

Mr. SMITH. Dr. Burtless, did I understand you to say you support the kind of investment limitations, such as the thrift savings account, but still that could be an individually owned investment accounts?

Mr. BURTLESS. My view is that if you are going to have individual accounts that represent a very small percentage of workers' pay, the only feasible way to do it is through the thrift savings plan-type operation where you offer people perhaps four or five investment options. The Treasury or the Social Security Administration could collect people's contributions. It could use a bidding process to hire the least expensive manager to handle the investment funds. And it could delegate the voting of the investment shares to third parties. Then the Social Security Administration would distribute money that is in these individual accounts to workers upon their death or their retirement. That is, I think, the only feasible way to manage small individual accounts.

The idea that you can have individual accounts managed by Fidelity and a thousand other investment companies only becomes feasible if contributions represent a big percentage of people's pay, 1 or 2 percent is just not enough.

Mr. SMITH. Mr. Herger.

Mr. HERGER. Thank you.

Dr. Burtless, I am happy to hear you say that none of us know the answers, or obviously we would be President, we would be running things if we did. But it seems to me the system we have now almost could be described as mutually shared misery. If all you are going to live on was what you get from Social Security, I mean, no one can live on that. So—but at least—and my understanding was it was never meant to be a full retirement; it was supposed to be something that people could fall back on. Hopefully, they would save some money during their lives and have something else in addition to this.

But I think this idea of maybe at least continuing to guarantee that, that minimum amount—which again is not enough for anyone really to live on—and this idea of having maybe a couple percent, or whatever it is, more that people can invest in the type of investment that we, as Federal workers, have I think is exciting.

I serve on the Ways and Means Committee. We had an individual who had set up, or helped set up in Chile this system, and he was saying how exciting it is in Chile. People walk around with these little, their little red books that show how much they have invested to see how much it has grown; and quite frankly, I find it kind of exciting myself, over the years that I have been in Congress, to have invested some in this savings plan that we have and to be able to look at, see—we have had incredibly good years here that we certainly can't expect to go on forever, but it is exciting to see this—as Einstein said, the most powerful force is compound interest—to see how this account is building.

So I think that this prospect of perhaps guaranteeing this, at least this floor of mutually shared misery that I would frame Social Security currently being at—at least guaranteeing that; plus giving people hope and maybe encouraging them more to invest—and particularly those who haven't been investing before—is an incredibly exciting concept, at least for me.

Mr. IBBOTSON. I share your excitement, but I also share Dr. Burtless' concern about the guarantee here, because the guarantee that you are talking about for these miserable current benefits is really more than we can afford, though. It is not—it is a liability that is uncovered, and it may not be enough to live very well on, but it isn't just a guarantee that we can make and then have something good happen on top of it.

I am thinking that we just can't—we can't guarantee at the level we are at.

Mr. HERGER. But that is what we—in essence, that is what we have been doing since 1935; is it not? We are basically guaranteeing, if not stated, at least very explicitly implied that we are guaranteeing that in the form of Social Security that we currently have.

Mr. IBBOTSON. We are guaranteeing it, we have been guaranteeing it, and our problem is that we can't afford the pay-as-you-go system to continue to guarantee it because the dramatic shift in the number of workers, far less workers per retiree——

Mr. HERGER. Beginning in 2012 or 2013; I understand that. But I think what is exciting, about this plan at least—and I don't claim to be an expert on it, because I am not—but at least the Archer-Shaw plan is that you would actually get to a point where we wouldn't need it after a period of time, and one would actually take the place of the other. We wouldn't be in this position where we are now of having this unfunded liability incredibly that we have.

Mr. IBBOTSON. That is what makes the top part of this so exciting to all of us here, that perhaps in this additional piece it could be big enough to cover some of the guarantees and some of the—and perhaps some upside. But without some extra payments in, we certainly——

Mr. HERGER. Right.

Mr. IBBOTSON.—we can't even make the guarantees of where we are, much less add anything on top of it.

Mr. HERGER. But as I understand it, his plan does have 2 percent on top of, which is additional, at least now, while we have this surplus.

Anyway, thank you very much, both of you.

Mr. SMITH. Well, I would close on an interesting bit of trivia.

In researching the testimony back in 1934 and 1935, the Senate argued very vigorously, and two votes in the Senate insisted that private investment options for retirement savings should be an option to the fixed benefit program of the government and that wasn't changed until they went to conference committee between the House and the Senate where a decision was made that we should disallow any individual the ability to make those retirement investments. So a decision in conference committee was made to have the fixed benefit program that we have now that has got us into a great deal of problems.

Let me just say that 3 weeks from today we hope to cover the issue of, Is the Social Security Trust Fund Real, and to what extent is there a difference between when we run out of tax money to pay benefits and the year 2034 when the actuaries say that it becomes an actuarial problem. So is the trust fund real, and how is the government going to pay that back if they do pay it back?

Two weeks from today, May 25, will be the national retirement reforms in other countries. Testifying will be Dan Crippen, Director, Congressional Budget Office; and David Harris from Watson Wyatt Worldwide, and Lawrence Thompson, a Senior Fellow at the Urban Institute.

Next week will be titled Establishing a Framework for Evaluating Social Security Reform with Dr. Robert Reischauer from The Brookings Institution and Steve Entin from the Institute for Research on the Economics of Taxation.

So, gentlemen, again, thank you very much for your time and effort to be here today. Your testimony will be entered in total in the record, as well as your comments. Thank you very much for helping us.

[Whereupon, at 1:30 p.m., the task force was adjourned.]

Cutting Through the Clutter: What's Important for Social Security Reform?

TUESDAY, MAY 18, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12 noon in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Members present: Representatives Smith, Herger, Ryan, Toomey, Bentsen, and Holt.

Mr. SMITH. The Social Security Task Force will come to order.

During the past 50 years, Congress has enacted reforms that both expanded and contracted the Social Security program. In 1972, Congress increased benefits by 20 percent. The following year, as the House of Representatives voted for an additional 11 percent increase—raising benefits by more than 30 percent in just 2 years—Representative Barber Conable stated, "Nobody is worrying about where we are headed with Social Security. We better not put off a careful review much longer if we are to face the next generation with as much sympathy as we are here showing to the last generation."

In less than 5 years, the system faced financial crisis. Congress passed legislation in 1977 that included tax increases and benefit cuts to "fit" Social Security's problems.

By the early eighties, Social Security again faced insolvency. Representative Conable was among the experts who served on the Greenspan Commission, which recommended reforms that were to assure Social Security's long-term health. Many of the recommendations of the Greenspan Commission were enacted by Congress in 1983. Despite these reforms, Social Security today has a $9 trillion unfunded liability, and is facing a cash deficit as early as 2013.

This short history only serves to emphasize the difficult task we face as we again work to recommend changes that will bring long term solvency to Social Security. During the past months, we have heard about many problems with reform. Now it is time to think about overcoming these problems and implementing solutions that end the cycles of insolvency that Social Security has experienced in the last 20 years.

PREPARED STATEMENT OF THE HONORABLE NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

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In less than 5 years, the system faced financial crisis. Congress passed legislation in 1977 that included tax increases and benefit cuts to "fix" Social Security's problems.

By the early eighties, Social Security again faced insolvency. Representative Conable was among the experts who served on the Greenspan Commission, which recommended reforms that were to assure Social Security's long-term health. Many of the recommendations of the Greenspan Commission were enacted by Congress in 1983. Despite these reforms, Social Security today has a $9 trillion unfunded liability, and is facing a cash deficit as early as 2013.

This short history only serves to emphasize the difficult task we face as we again work to recommend changes that will bring long-term solvency to Social Security. During the past months, we have heard about many problems with reform. Now it's time to think about overcoming these problems and implementing solutions that end the cycles of insolvency that Social Security has experienced in the last 20 years.

Successful reform needs bipartisan support. I encourage my colleagues to work with me to make 1999 the year we enact Social Security reforms that puts this important program on a solid foundation for the 21st Century.

Dr. Reischauer, you have testified before various congressional committees. You have been testifying and talking to the budget committee over the years and we look forward to your testimony.

Mr. Entin, we will start with you for approximately 5 minutes, five to 7 minutes and then Dr. Reischauer for five to 7 minutes.

Ken, unless you would like to make a statement early on here?

STATEMENT OF STEPHEN J. ENTIN, EXECUTIVE DIRECTOR AND CHIEF ECONOMIST, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Thank you, Mr. Chairman, it is a pleasure to be here this afternoon.

My name is Stephen J. Entin. I am the Executive Director and Chief Economist of the Institute for Research on the Economics of Taxation. I did serve in the Treasury, but only in the Reagan Administration. I left between Mr. Baker and Mr. Brady. Two Secretaries were enough and I thought time to move on.

I did work on eight Social Security Trustees' reports, which was quite an experience, and before that I worked on the issue on the Joint Economic Committee Staff. So I have been following Social Security issues for more than 20 years.

I had some thoughts about what you might focus on in designing a new or reformed Social Security/Retirement System. In thinking about Social Security reform, we need to keep something very important in mind. This is not just about Washington and it is not just about the Federal budget. It is primarily about a better retirement system for Americans and a more productive working life for Americans.

To date, the Federal budget issues and the concerns of Washington policy makers relating to Social Security seem to be driving the debate rather than what is best for the economy and for the people as they work and retire.

Rigid budget rules and static revenue estimation could prevent the adoption of the most effective reforms. We need to sweep such impediments aside and give more attention to the interests of the people and the consequences for the economy.

The most important thing to remember is this. We need higher output and productivity to support a rising retired population. Retirees and workers will want to consumer higher levels of real goods and services. Someone has to produce them.

If productivity of future workers is higher than currently, they will be able to support the added consumption of the more numerous retirees without dipping into their own consumption. If we do not improve the productivity of the economy, growing numbers of retirees will force a reduction of the living standards of future workers. Or, we will have to curtail the benefits we are promising the retirees.

Higher real output requires fewer unfunded transfer payments and more real saving and investment. A funded saving system will always outperform a tax/transfer system due to real investment and compound interest.

When you design the new system, please judge the changes both in the design of the new system and in the financing of the transition with that real growth objective in mind.

In short, we must make workers more willing to work, savers more willing to save, and investors more willing to invest in expanded economic capacity.

You can make workers more willing to work by letting them divert a portion of their payroll tax to personal accounts, and allowing the saving to build tax-deferred, as in an IRA.

If you design the new system carefully, workers could get 2 to 3 times what Social Security can afford to pay with only half the contributions that they must now put into Social Security. Workers would get more after-tax benefits from their earnings over their lifetimes, in effect receiving a higher compensation package, which would increase the incentive to work.

The increased work incentives depend on the reform's allowing a "carve out" rather than an "add on" approach to obtaining money for the required saving accounts. It also assumes that the workers benefit substantially from the retirement savings.

For the saving to have the maximum value to the workers, they must be free to use all or much of the money as they see fit. The withdrawals must not be so severely regulated, or taxed, or tied to reductions in other retirement benefits, or so completely tied up in redistribution arrangements such as mandated annuities, that the workers question their value. The accounts must be the workers' money, not Washington's.

Bear in mind that saving in the retirement accounts may substitute for other saving. It may displace some foreign capital inflows, or it may flow abroad (and should be free to do so if workers can get higher returns in global mutual funds). The saving going into the new accounts will not automatically lead to higher domestic investment and wages in the United States, unless we take steps to reduce the taxes on domestic investment to encourage people to put the saving to work here.

Consequently, to ensure a good outcome, please combine the Social Security reform with investment incentives such as expensing or faster write-offs of plant and equipment (that is, shorter asset lives).

Also, be sure to give the saving accounts IRA treatment, and extend IRA treatment for other forms of saving so that it does not decrease as the result of the policy change. Ideally, we would adopt a full blown tax reform to promote domestic investment and saving. The two reforms would be mutually supportive.

A few other design issues of note:

Do not keep younger people in the system. Bring it to a close some day.

Do not confuse retirement saving systems with welfare. There should be a safety net, but you do not have to mix it with a retirement plan that will be unproductive for future participants under current projections.

Do not have government running the show or owning or voting stock in U.S. businesses.

Next, let me turn to the financing and transition issues.

I do not think you need to hurt current retirees by crimping COLAs. I do not think you should cut benefits much for people age 55 and above. They do not have time for compound interest to work in their favor very long.

However, do cut government spending wherever else you can to free up resources for private sector expansion. That gives the best outcome, as you can see from the charts attached to my testimony.

Do not borrow any more than you have to. It either takes saving away from investment, or forces reliance on foreign capital, which means that foreign savers and lenders to the United States get the earnings from the investments, instead of the U.S. retirees.

Do not raise taxes. Cutting taxes on labor just to raise them again or to raise taxes on labor and capital does not do any good in promoting incentives to work or to save and invest. Substituting income tax increases on labor and capital for payroll taxes on labor would actually reduce the trend rate of growth, because capital is more sensitive than labor to taxation.

You might sell some Federal assets. This would help you with your short term financing arrangements. However, unless the assets are totally out of use, selling them would not add much to GDP, but it might help your short run budget picture.

Do take account of the higher output that a good reform of the retirement system could trigger in calculating the revenues that you would have in the future. Do dynamic estimation, not static.

And again, to make sure of a good outcome: Do include some investment incentives.

I have just a few other considerations and then I will stop. Please do not do another patch job as in 1977 and in 1983. The Chairman has referred to these and how they did not really take hold and work. The problem is not merely the very small long-term average deficit of 2 percent of payroll that you see in the Trustees' report.

This is one of those reforms where more is better than less. The more people can put their own saving to work in a real funded system, the better the retirement income picture is going to be.

Finally, trust the people. They can manage their own affairs to a considerable degree. They can hire other people to help them if they feel they cannot do their own investing. They are the ones who are most interested in their own futures and they are the ones you can trust with their own money.

We have the money to proceed, fortunately because of the good economy and the strong budget picture. We barely have the time to proceed. We need to tackle Social Security reform and tax reform together. They reinforce one another and we need to start now.

Thank you.

[The prepared statement of Stephen J. Entin follows:]

PREPARED STATEMENT OF STEPHEN J. ENTIN, EXECUTIVE DIRECTOR AND CHIEF ECONOMIST, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Social Security reform is essential to give workers a better means of providing for their retirement income than the current system can possibly deliver. The reform effort has been given great urgency by the rapid approach of the retirement of the baby boom generation, which will throw Social Security into deep deficit, and create an enormous budget problem for the Federal Government.

The objective of reforming the current system of providing retirement income must not simply be to avoid future Federal deficits when the baby boom retires. The objective must be to adopt a new approach to providing retirement income that improves the functioning of the economy and the incomes of people at all stages of their lives, and that avoids future budget problems as well. Furthermore, the new system must be designed under realistic dynamic assumptions about its impact during and after the transition on the economy and the Federal budget.

Many Social Security reform proposals would allow workers to divert a portion of their payroll taxes to personal retirement accounts in exchange for reduced future Social Security benefits. Because of the higher returns available on private saving, workers could be made substantially better off as a result. The economy would improve as well. Meanwhile, however, benefits to current retirees would still have to be paid. If payroll taxes were diverted to personal accounts, the government would have to finance the resulting gap in the Federal budget. To date, the Federal budget issues and the concerns of Washington policy makers relating to Social Security seem to be driving the debate, rather than what is best for the economy and for people as they worker and retire. Instead, the interests of the people and the consequences for the economy should be given more attention in designing an alternative system and handling the transition.

STATIC REVENUE ASSUMPTIONS AND RIGID BUDGET RULES DRIVING THE PROCESS

Each point of payroll tax reduction would cost about $36 billion in revenue annually as of 1999, rising to $45 billion by 2004. These figures assume no economic gains and revenue reflows from the reduction in the payroll tax. Thus, to leave budget deficit or surplus projections unchanged, cutting the payroll tax rate by, for example, 5 percentage points would require trimming Federal spending, increasing borrowing, or raising other taxes by about $180 billion to $225 billion per year, under static economic assumptions.

The authors of a number of reform proposals have incorporated specific amounts of Federal borrowing, tax increases of a particular level and duration, and reductions in future Social Security benefits in their plans to pay for the transition to their new retirement income systems. In making these estimates and offsets, they have often followed restrictive budget scoring rules, conventions, or assumptions that limited their options and colored their results.

The Social Security Administration follows the Federal budget convention of employing static economic assumptions, in which the effect of a tax or spending change on the economy and of the resulting change in the economy on Federal revenues and outlays are ignored in estimating GDP and the budget numbers. Furthermore, the Federal budget rules require that tax and entitlement changes be matched by offsetting changes in the same budget categories. Consequently, the last official Advisory Council on Social Security restricted its tax and spending recommendations to the Social Security accounts, and made no forays into other Federal taxes and outlays. These efforts may provide the appearance of a workable transition to an alternative retirement plan on paper, but they may fall far short in practice, and may not be the optimal approach.

Budget Surpluses to the Rescue?

Projected budget surpluses might eliminate the requirement of budget neutrality and allow for a net tax cut in connection with Social Security reform. For example, the National Commission on Retirement Policy wants to reserve projected surpluses for funding part of its proposal to divert 2 percentage points of the payroll tax to personal saving accounts that, unlike the current trust fund, need not be invested in Treasury bonds.

Unfortunately, the economy might not continue to expand as vigorously as in recent quarters, nor throw off large revenue increases, unless some of the rising revenue stream is "reinvested" in the expansion through growth-enhancing tax rate reductions on capital and labor inputs. Fundamental tax reform is an attractive competing use for surpluses, and would enhance investment and saving incentives by moving toward a consumed-income based tax system. Short of full-scale tax reform, growth-enhancing tax changes might include faster depreciation or expensing of investment, reduced double taxation of corporate income and capital gains, expanded IRA and pension eligibility and contribution limits, and lower tax rates on labor income.

In the presence of a surplus, then, the trade-offs are between cutting the payroll tax as part of Social Security reform and either paying down a portion of the national debt, cutting other taxes, or increasing Federal spending. As will be discussed below, the chances for a successful reform of Social Security would be greatly enhanced if the reform were coupled with reductions in the taxation of domestic investment and saving.

Needed: A Broader Objective—Enhanced Saving, Productivity, Investment, and Income

Various alternatives to the Social Security System and the various means of financing the transition would have important effects on individual and business behavior and on the economy as a whole. These effects are too important to ignore, either in the design of the new system or in choosing how to finance the transition.

Ultimately, caring for a relatively larger retired population will require a more productive work force in the future. Future retirees will want to consume goods and services produced by future workers. If future workers are sufficiently more productive than workers today, then future retirees and future workers can both enjoy a rising standard of living. If not, then the rising numbers of retirees will cut into the living standards of future workers, or future retirees will have to make do with lower living standards than they are being promised. If the baby boom and later generations are to be self-reliant in retirement, steps must be taken now to increase their saving and the rate of investment and productivity growth in the United States.

Increasing the financial assets and incomes of future retirees and raising the productivity of future workers can work hand in hand. If workers are able to save more for their own retirement, they will be more self sufficient upon retirement and make fewer demands on future workers for support. Their saving will add to capital formation somewhere in the world, and enable them to consume the added output that their added saving has produced, rather than tap into the income and output of their children and grandchildren. Furthermore, if the saving is put to work increasing the stock of physical capital and human capital in the United States, then U.S. workers will be more productive and better paid throughout their lives.

The push to overhaul of Social Security is driven in part by growing awareness that a program of real funded saving would be better than the current unfunded pay-as-you-go system at raising employment, investment, productivity, and income. Proposals to replace Social Security with a funded personal saving system and methods of financing the transition must be judged with that saving and investment objective in mind. Four key elements are involved: the labor supply, personal saving, national saving, and domestic capital formation. A well-crafted reform should increase all four.

If a switch to private saving were done in a manner that improves the performance of the economy, it would reduce the net cost of the transition, and reduce the amount of transition funding that would be required. These dynamic revenue effects should be considered when formulating the reform program.

Labor Market Effects of Reform

Diverting a portion of the payroll tax to personal accounts, and allowing the saving to build tax-deferred, as in an IRA, would increase the amount of retirement income available to workers. The returns would exceed those possible under Social

Security. Workers would get more after-tax benefits from their earnings over their lifetimes, in effect receiving a higher compensation package, which would increase the incentive to work. Labor force participation and hours worked would rise.[1]

A larger, more willing labor force would give the capital stock more labor to work with, boost the returns on capital, and trigger some additional investment and saving. These labor market effects are moderate in magnitude but are highly likely to occur. They would result in a significant improvement in personal income and national output.

Higher employment would result in additional income and payroll taxes. Increased availability of labor would boost the return on capital, and induce some additional investment and yield some additional business taxes.

The increased work incentives depend on the reform's allowing a "carve-out" rather than an "add-on" approach to obtaining money for the required saving accounts. It also assumes that the worker benefits substantially from the retirement savings. For the saving to have the maximum value to the workers, they must be free to use all or much of the money as they see fit. The withdrawals must not be so severely regulated, or taxed, or tied to reductions in other retirement benefits, or so completely tied up in redistribution arrangements such as mandated annuities that the workers question their value.

FREEDOM TO CHOOSE

Workers will place the maximum value on the new system if they have significant freedom of choice in how they participate. They should have choices of how to invest their money, how much to contribute, when to withdraw it, and how to withdraw it. There should be no minimum retirement age. If a worker has saved enough to buy a minimum retirement annuity, he should be free to begin to make withdrawals at any age, or to scale back his contributions. Workers should not have to run their retirement plans through the Social Security Administration, or be limited to three investment options as under the Federal Employee Retirement System. Private fund managers or workers should have voting control of the stock in the accounts. Stock should not be owned or controlled by a Federal agency.

CARVE-OUT VS. ADD-ON

Requiring that people save a portion of their income over and above current "contributions" to Social Security would not yield the same gains in work incentives as a carve-out of the payroll tax. Under mandatory saving, individuals retain their ownership of the income, and have access to it at a later date, with interest. However, the mandated saving forces individuals into a different use of their income, and a different time pattern of saving and/or consumption, than they would have chosen freely. It is a "tax" to the extent that it reduces their utility. The inconvenience may be substantial for low income wage earners who have little room to reduce current outlays.

Government could require people to save a certain portion of their income starting immediately, and gradually phase out or reduce Social Security benefits for future retirees, and gradually reduce the payroll tax in distant decades as it is not needed to pay benefits. Such a program would not be well received by the affected generations. For generations working prior to the payroll tax cut, it would make Social Security, already a bad deal, even worse.

It is for these reasons that reform proposals usually attempt to improve the deal for current workers by giving them a tax break or other assistance to help them save. The assistance would not have to match the benefit cut dollar for dollar because the returns from private saving exceed projected Social Security benefits. In a sense, the public would be willing to buy its way out of the program.

FORCED ANNUITIZATION

Some reform proposals developed in Washington would require that all the assets in mandated personal retirement accounts be converted to annuities upon retirement. The stated objective is to protect the worker from outliving his retirement income. In fact, the objective may be to protect the government from the possibility that some retirees may spend down their retirement funds too fast and end up asking for public assistance in their very old age.

While annuitization is insurance against living too long, it is also a gamble that one will not die too soon. If a worker dies the year after retiring, he will get vir-

[1] See, for example, the labor market discussion in Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," American Economic Review (May 1996).

tually nothing back on his annuity; nearly all his assets will go to someone else in the annuity pool who lives longer than average. Annuities die with the beneficiary (or beneficiaries, in the case of a joint annuity). There is generally no residual asset to leave to heirs.

Forcing retirees to convert all the saving in their retirement accounts to annuities goes too far. The government's only legitimate interest is to avoid having to support the destitute. At most, a safety-net level annuity should be all that is required. Alternatively, require that a minimum balance be maintained in the account, according to age. Workers should be free to use assets in excess of such amounts any way they like, including leaving an estate for their children.

Capital Market Effects

The effects on saving, investment, and income from a well-designed reform could be even greater than the positive labor force effects. Cuts in the cost of capital can yield very large increases in the capital stock because the productivity of capital declines very slowly as the quantity rises. However, positive effects on investment may depend critically on how the reform is structured, and are not a sure thing.

Some studies[2] have assumed that most of the saving in the personal saving accounts set up under reform would represent an increase in total saving by Americans, and that the additional saving would translate almost dollar for dollar into additional investment by businesses in the United States. The additional investment is assumed to earn the current rate of return, yielding higher levels of taxable business income, and generating significant revenue reflows to help pay for the transition.

There are a number of problems with this scenario.

The saving in the new retirement accounts may substitute for other saving being done by Americans. The accounts will not reduce the tax on other forms of saving, nor make it more rewarding to save, at the margin. Low income workers who now save very little would be likely to save more due to the new accounts. Absent better tax treatment of ordinary saving, however, other savers might substitute the required retirement saving for some of the saving they are currently doing.

Furthermore, we live in a global economy. Additional saving by U.S. residents may be invested abroad through global mutual funds or other foreign assets, or displace some foreign lending to the U.S. (Americans should have the option to invest abroad to achieve diversification and the best yields; it would be unwise and ineffective to try to shut the saving in.) Consequently, saving available in the United States may not rise dollar for dollar with the increase in domestic saving.

There is also no guarantee that businesses will be eager to borrow the additional saving and invest it in the United States. Without a change in the tax treatment of investment in plant, equipment, structures, or inventory in the United States, business may not want to add to domestic capital. If the rate of return on financial assets falls as a result of the additional saving in the new accounts to entice businesses to borrow, it may discourage other saving by Americans or discourage capital inflows from abroad. Even if American businesses borrow the added saving, they may invest the proceeds abroad to obtain higher returns. Since saving appears to be sensitive to the rate of return, these offsets could be significant. They would reduce domestic employment, income, and tax reflows.

Finally, if additional investment were to occur, the higher capital stock would depress the rate of return on capital, depressing profit and government revenue reflows below levels that might otherwise be anticipated.

For all these reasons, there would be no cause to expect the saving in personal retirement accounts to result in dollar for dollar increases in private U.S. saving or the stock of physical capital in the U.S. Both would increase, but by how much is uncertain. Some revenue feedback would be likely, but the very large amounts predicted by some papers on the subject appear to be overly optimistic.

Policy Steps to Ensure a Favorable Outcome

Steps could be taken to ensure that the accounts do not reduce other saving, and to encourage businesses to take up the additional saving in order to expand investment in the United States. In particular, faster depreciation or expensing (immediate write-off) of plant, equipment, structures, and inventory, would raise the after-tax return on investment sited in the United States. The return to U.S. savers

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[2] See, for example, the capital market discussion in Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," American Economic Review (May 1996); also, Peter J. Ferrara, "A Plan for Privatizing Social Security", CATO Institute Social Security Paper No. 8, April 30, 1997.

would be increased. There would be less chance that other saving by U.S. residents would fall, less chance that foreign investment in the United States would decline, and more incentive for businesses to use additional saving to expand their operations in the United States as opposed to abroad.

Further steps to increase domestic saving, such as easing contribution limits and eligibility requirements for IRAs and pensions, reducing the double taxation of dividends and the taxation of capital gains, and ending the estate tax, would all increase the incentive to save.[3] In effect, Social Security reform would be greatly assisted by adopting the tax treatment of saving and investment recommended in all the major consumed-income-based tax reform proposals that attempt to end the income tax bias against saving and investment. Tax reform and Social Security reform are not only compatible, they are mutually reinforcing both philosophically and in practical terms.

FINANCING OPTIONS FOR THE TRANSITION AND HOW THEY STACK UP IN FURTHERING SAVING, INVESTMENT, AND WORK INCENTIVES

There will be many specific proposals for dealing with the Federal budget implications of the transition, with many variations as to details. Fundamentally, however, all the financing options are variations on a small number of themes: cut Federal spending, increase Federal borrowing, raise taxes, and sell assets. (Again, in surplus terminology these are: less Federal spending than otherwise, less debt repayment than otherwise, less tax reduction than otherwise, and asset sales.) One could reduce the amount of funding required by recognizing the positive budget effects of Social Security reform as the higher levels of saving, growth, income, and employment it generates raise revenues and reduce social safety net outlays (dynamic scoring).

The choice of transition financing will have important consequences for personal saving, national saving, and domestic investment. Assuming a budget neutral approach, one can describe the possible outcomes as follows: On- or off-budget cuts in Federal spending would permit the transfer of some portion of general revenues to the Social Security retirement and disability programs (OASDI), or would stretch remaining payroll tax receipts further to support current retirees, with no adverse economic effects. Higher income or payroll taxes to support OASDI during the transition would reduce incentives to work and invest, depress private saving, and would cancel out potential increases in national saving and growth. Federal borrowing would not be helpful. If the nation is to benefit the most from privatization, the saving in the retirement plans should be used to add to the stock of private capital, raise productivity, and increase employment and wages, not to finance additional deficit spending. Finally, for the greatest benefit, the increased investment should be located in the United States. Ensuring an increase in domestic investment in plant, equipment, and structures requires improved tax treatment of domestic investment spending by businesses.

SPENDING CUTS

Federal spending cuts have the potential to raise national saving more than other methods of financing the transition. The greater are the spending reductions (or the less the increases that would otherwise occur), the less that the government would be borrowing or taxing away the nation's scarce saving, and the more that the saving could be directed toward additional capital formation. Furthermore, if the government were to spend less on goods and services, it would be absorbing fewer real resources (e.g., labor and materials), freeing them for private investment or other uses, such as investment. However, cutting government spending deprives the public of the value of the government services foregone. Their value must be weighed against the value of the additional personal savings and retirement income that the cuts would make possible, and the costs of alternative methods of financing the transition.

The best way to finance the transition to private saving for retirement is to trim on-budget Federal spending for goods and services. Unfortunately, the PAYGO budget rules require that tax reductions be offset by tax increases or entitlement cuts. Worse yet, OBRA90 made it a violation of budget rules to weaken the 5-year and 75-year "actuarial balance" of the OASDI trust funds. These rules require that

[3] Ideally, all saving, whether mandated by the Social Security reform program or done in addition to the required amounts, and whether for retirement or not, should receive pension treatment. Either the contributions and earnings should be tax deferred until withdrawal, as with a deductible IRA, 401(k) plan, or company pension; or the saving should be on an after-tax basis, with no tax on withdrawals, as with a Roth IRA.

offsets to a payroll tax reduction be made within the confines of OASDI, rather than by means of cuts in on-budget discretionary Federal spending or other entitlements. The budget rules must be eliminated or waived to produce a sensible Social Security reform. (H.R. 3707, introduced in the last Congress by Representatives Sam Johnson (R-TX) and J. D. Hayworth (R-AZ), and S. 1392 introduced by Senator Sam Brownback (R-KS) would allow discretionary spending cuts to be used for tax reduction.)

People would have to choose between the government spending or the tax relief, retirement income increases, and improved job opportunities that people could get from additional private saving. If the question were put to them squarely, they might well decide that nothing that government spends money on (with the possible exception of basic national defense and medical research) is as valuable as replacing payroll taxes with private saving.

It would be difficult to cut Social Security benefits for current recipients or people close to retirement. Current Social Security beneficiaries will get relatively little of the economic and personal financial gains of the switch to a funded personal retirement system. They will not share in the rise in wages, unless they are still working while drawing benefits. It seems unreasonable to impose much of the cost of the transition on people already drawing benefits. People in their late 50's, who are soon to retire, have little time to save to replace lost benefits. It is unreasonable to place any great burden on this group. However, the projected growth in real per capita Social Security benefits (a rough doubling over the 75 year planning period) should be scaled back for future retirees to bring the system into balance with projected tax revenues. That much adjustment would be necessary even if fundamental reform were not undertaken.

BORROWING

Federal borrowing could be increased (or debt reduction reduced) to pay for a portion of the transition costs. However, additional Federal borrowing of an amount equal to the deposits in personal retirement accounts would effectively divert the additional saving to financing the deficit rather than increasing private investment. Savers would either purchase the additional Federal bonds directly for their retirement accounts, or they would purchase existing stock or private sector bonds from other individuals who would, in turn, buy the additional Federal debt. Either way, the saving would not be invested in additional private sector securities issued to finance additional private sector investment. The best that can be said for borrowing is that it is less damaging to saving, investment, employment, and output than tax increases. It should be used sparingly.

Borrowing is often described as a way of spreading the cost of the transition over several generations. This is a misconstruction, and describes only the management of the Federal budget, not the economic "cost" of the transition. In terms of real economic consequences, transfer payments are always paid for in the year they are made. People who receive transfer payments in a given year can purchase goods and services in that given year. Others in the population must give up income and the enjoyment of goods and services in that given year, either in the form of higher taxes or reduced ability to borrow for their own uses the saving absorbed by the government.

BORROWING CANNOT BOOST NATIONAL SAVING

The real cost of the transition from an unfunded to a funded retirement system is the cost of adding to national saving and investment to provide future retirement income. The cost of adding to saving and investment is the current consumption that must be given up. If we continue to pay benefits to current retirees, maintain other current consumption, and still want to boost the stock of plant and equipment in the United States, we can do so only insofar as foreign savers are willing to increase their lending to the United States to finance our investment. Borrowing to save does not increase net worth or national saving in the present. National saving would rise only in the future as the debt was serviced and repaid. The cost of the future Federal debt service and repayment would equal the Federal borrowing in present value. Put another way, the added national income from investments made with borrowed money would have to be devoted to serving the added debt. It would not be available for spending by retirees.

TAX HIKES

Tax hikes to finance the transition would be self-defeating if the objective is to cut taxes to assist current workers to save. Individual and corporate income tax rate increases or curtailed depreciation write-offs would reduce the incentive to save and invest and reduce income available for saving and investment. Payroll tax increases that offset the redirection of the payroll tax to individual retirement accounts would reduce the incentive to work and to hire. All would reduce the future productivity growth and growth of real output necessary to ease the burden of caring for an aging population.

Failure to use a budget surplus to cut taxes on saving, investment, and work would have the same adverse consequences, compared to what could be achieved by appropriate tax relief. Current budget surpluses could help to pay for future Social Security outlays only if they were used to reduce taxes in a manner that increased saving, investment, work incentives, and the productivity of future workers.

ASSET SALES

Asset sales could produce some immediate revenue for the government and help with the near term budget problem during the transition. However, asset sales would primarily affect the timing of government revenue without having much effect on the government's "balance sheet," national saving, or the performance of the economy.

Asset sales would reduce government borrowing in the current year. However, the purchasers would have to use their own current saving or borrow to pay for the assets, reducing the availability of private saving for other investment by as much as the reduction in Federal borrowing. Consequently, there would be no increase in national saving from an asset sale. The sale of government-owned financial assets, such as loans, would provide current revenue for the government, but would reduce future interest income by the same present value. There would be no permanent benefit to the Federal budget.

Similarly, the sale of government-owned real property currently leased to the private sector would provide current revenue for the government, but would reduce future revenue from leasing by the same present value, if the leases have been let at fair market rates. (If the leases are for less than market rates, constituting a subsidy, and if the property could be sold for fair value, the government would gain, but at the expense of the lessee.) Again, there would be no permanent help for the Federal budget. Furthermore, if the leased property is being put to its most efficient use, the privatization would not boost economic activity or output.

By contrast, sale of government property that has been withheld from productive use, or from its most valuable use, could increase the effective supply of economic resources for use by the private sector and expand economic activity. Furthermore, the new owners of the assets might invest in improvements to the properties that they would not do as leaseholders. Sale of this type of asset would generate some increase in national output.

DRAWING DOWN THE TRUST FUNDS (NOT AN OPTION)

The OASI and DI trust funds are not a means of payment of future benefits. Treasury must pay benefits from current taxes or borrowing whenever benefits are due. The trust funds represent past tax revenue that the Treasury "borrowed" from OASI and DI and spent on other government outlays. To acquire the money to "redeem" the Federal "bonds" in the trust funds to pay future benefits, Treasury would have to borrow additional money from the public, raise taxes, or cut other spending, just as it would have to do if the trust funds did not exist.

"Crediting the trust funds" with current budget surpluses, which would in fact be borrowed back by the Treasury to reduce debt held by the public, would in no way aid in the future financing of future Social Security benefits. Treasury would just have to borrow the money back from the public at a later date. It is nonsense to suggest that reducing the level of the national debt today would make it easier to add to it later to deficit finance future benefits. The future borrowing would cut into future saving and investment and reduce future output as effectively as if the debt had never been drawn down.

ILLUSTRATIONS OF POSSIBLE OUTCOMES OF REFORM UNDER DIFFERENT BEHAVIOR ASSUMPTIONS AND APPROACHES TO FINANCING THE TRANSITION[4]

The baseline projections reflect current law and use economic assumptions similar to those in the budget forecasts of the Congressional Budget Office and the Office

[4] The scenarios presented here were developed with the assistance of Gary and Aldona Robbins and simulated using the Fiscal Associates general equilibrium model. For more on the

Continued

of Management and Budget. Fiscal Associates extended the baseline to accommodate the longer time horizons used in Social Security projections. To avoid the need for a future tax increase, baseline benefits paid by the Old-Age and Survivors Insurance (OASI) program were reduced to eliminate the program's long-run deficit.

The attached charts illustrate optimistic and pessimistic assumptions concerning the saving and investment behavior of the public following Social Security reform. They also show that, for each set of assumptions, a range of outcomes is likely depending on the means chosen to finance the transition to the reformed system. The scenarios fully incorporate the labor market effects described above in all examples.

In the "strong saving response" case, it is assumed that the additional saving in the mandated accounts does not substitute for other saving, and that it lowers the cost of capital and stimulates investment substantially without further changes in the tax treatment of investment or ordinary saving. It assumes that cross-border saving flows are not so sensitive to changes in the rate of return that they largely offset the changes in domestic saving.[5]

In the "weak saving response" case, it is assumed that the additional saving in the mandated accounts displaces other saving in the absence of tax relief, and that it does not lower the cost of capital nor spur investment substantially without a change in the tax treatment of investment. It assumes a very open economy in which cross-border saving flows are highly sensitive to changes in the rate of return.[6]

A third case is illustrated in some charts. It assumes the weak saving and investment response, but adds a tax change—a shift from depreciation to expensing of investment outlays—to ensure that the reform generates the additional saving and investment that the "strong response case" takes for granted.

GDP—gross domestic product—is output generated in the United States by labor and capital, regardless of the nationality of the factor. The returns on foreign-owned capital located in the United States accrue to the foreign owners, not to U.S. residents. However, U.S. workers benefit from capital located in the United States, regardless of who owns it, because it raises their productivity and wages.

GNP—gross national product—includes income received by U.S. residents earned abroad, such as returns on capital that they own in other countries, less payments to foreigners of the income from assets they own here. One major objective of Social Security reform is to increase GNP, income of U.S. residents, not merely output in the United States.

Chart 1. Chart 1 shows the increase in GNP (percentage change from baseline) for a transition financed by reductions in government sending. The increase is large—nearly 8 percent of GNP—where the saving is largely new saving, and investment responds strongly. It is smaller—about 2 percent of GDP—where the investment response in lower. There is still a beneficial effect from the labor market response to higher retirement income from personal saving accounts. The chart illustrates the rise in the GNP from combining the mandated saving program with an improved treatment of capital investment. With expensing, the GNP rises more than 6 percent even under the weak response assumptions (and rises faster in the short run than in the strong case). Adding investment incentives to the reform greatly increases the chances for a favorable outcome.

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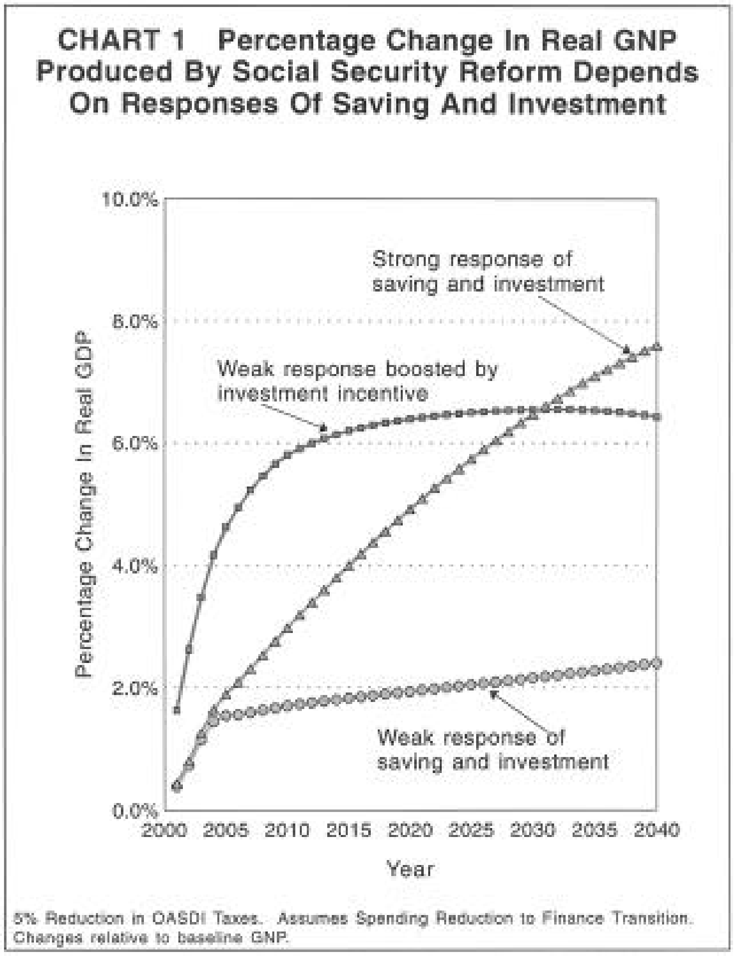
model, see Gary and Aldona Robbins, "Tax Reform Simulations Using the Fiscal Associates' General equilibrium Model" in the Joint Committee on Taxation Tax Modeling Project and 1997 Tax Symposium Papers, Washington, D.C.: Joint Committee on Taxation, November 20, 1997.

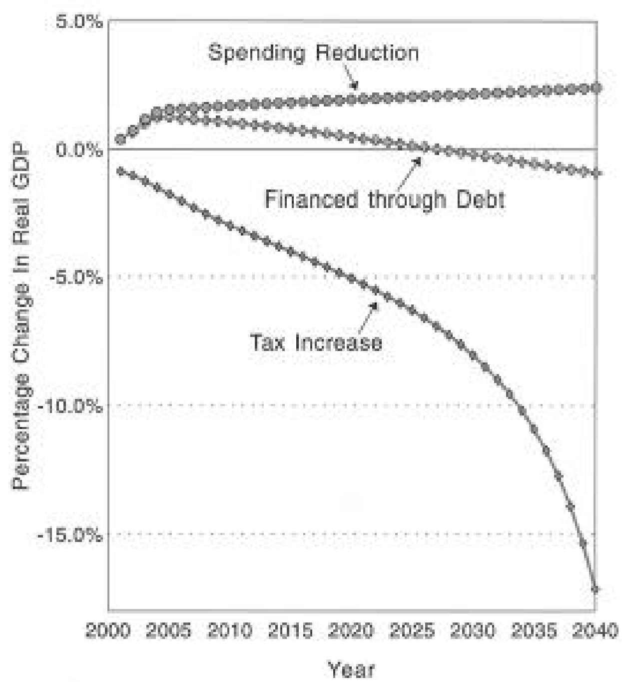
[5] The "strong response" illustration follows the normal workings of the Fiscal Associates model, which yields a more moderate outcome than the more extreme "strong response" described in the text. The model allows for a moderate reaction by other saving and foreign capital movements to changes in the relative risk-adjusted rates of return to capital inside and outside the United States.

[6] The "weak response" assumptions were designed by the author to be a foil for the extreme opposite viewpoint. They strictly apply "marginality;" if there has been no change in the tax treatment of incremental saving or investing, or in the relative returns at the margin here and abroad, not much will change. They assume a perfectly integrated world financial system, in which people supplying marginal saving regard domestic and foreign assets as perfect substitutes.



Charts 2 and 3. Chart 2, using the weak response case for illustration, and Chart 3, using the strong response case, show the different effects on GNP from three alternative approaches to financing the payroll tax cut and the transition—cutting government spending, borrowing, and raising other taxes.

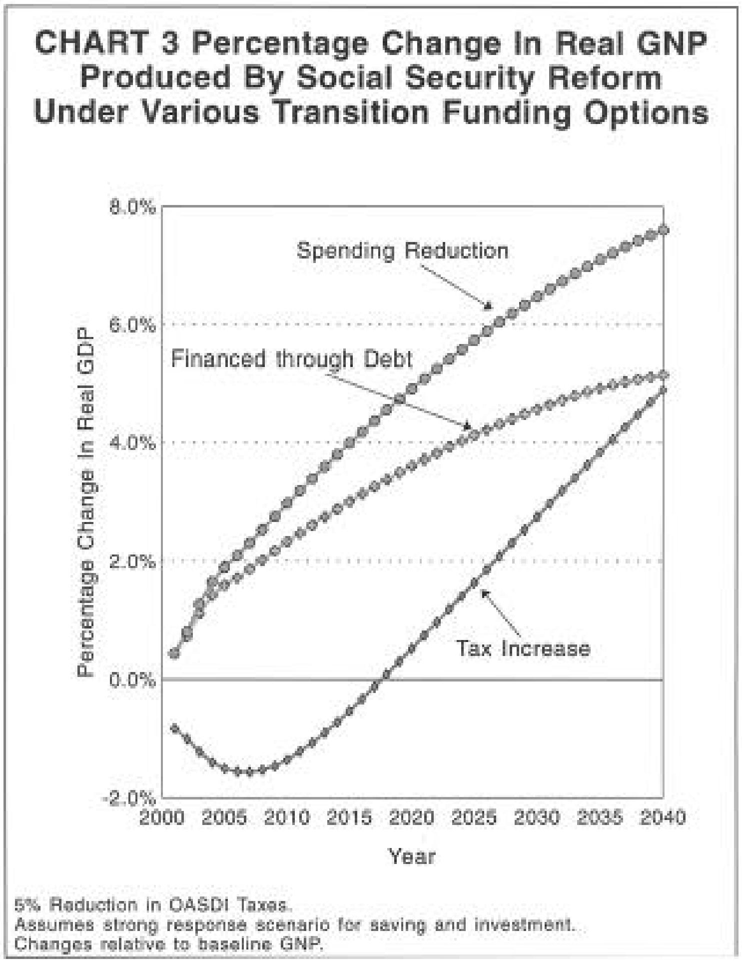
CHART 2 Percentage Change In Real GNP Produced By Social Security Reform Under Various Transition Funding Options



5% Reduction in OASDI Taxes.
Assumes weak response scenario for saving and investment.
Changes relative to baseline GNP.

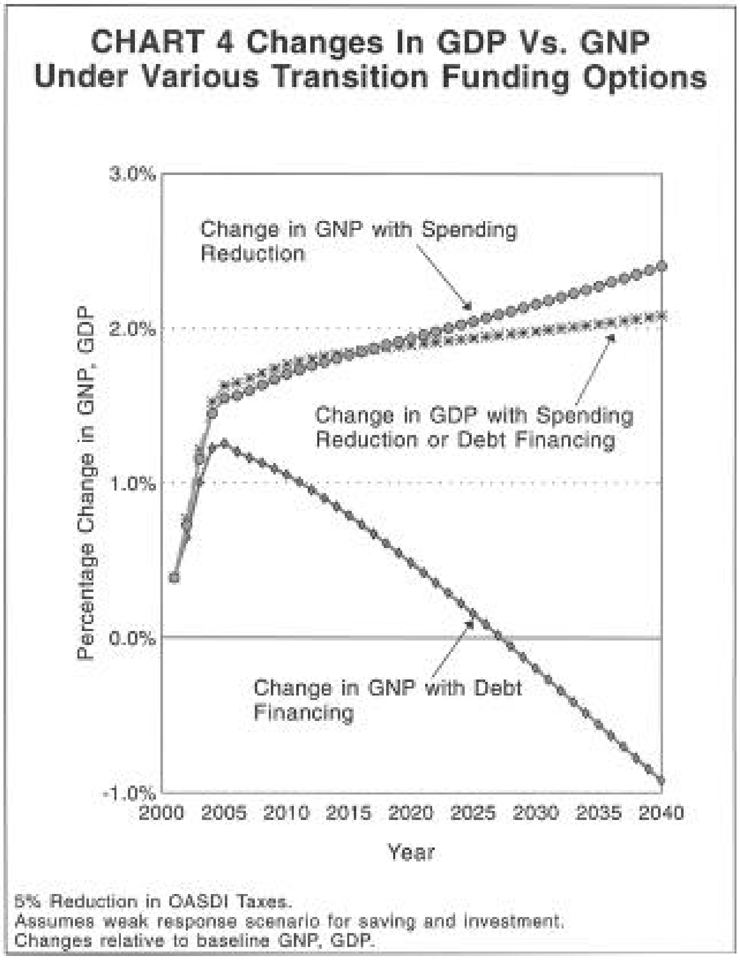
Cutting spending gives the best rise in GNP under either assumption about the strength of the saving and investment response. Spending restraint reduces the cost of capital by making additional real resources available to the private sector and permits added saving to flow into investment.

Debt finance comes in second. It forces the additional private saving to be returned to the government to finance added government debt, in which case the additional investment must be paid for by foreign savers, who then receive the capital income. (Alternatively, foreign savers buy the government debt, and U.S. residents must pay added taxes to pay the interest to the foreign lenders.) There is less gain to U.S. residents. In fact, in Chart 2, the weak response case, the increased borrowing, year after year, reduces GNP below the baseline. Workers earn more than under the baseline even in this case, but U.S. ownership of capital is reduced, and capital income drops below the baseline, reducing total U.S. income. If reform is to work well, there should be some reduction in government spending. For the best outcome, Washington should not try to hold itself harmless and impose all the cost of reform on the private sector.



The tax increase is the worst method of financing the transition. The tax increase is assumed to be across-the-board on labor and capital. Raising taxes on labor and capital to cut taxes on labor reduces GNP relative to the baseline in the weak response case. Employment and real after-tax wages would fall relative to the baseline. In the strong response case, the tax financing causes GNP to fall initially, later rising by less than under the other financing methods.

Chart 4. Chart 4 illustrates the different impact on GNP and GDP of borrowing to finance the transition. Borrowing does not prevent additional capital from being installed to utilize the additional labor induced by the payroll tax reduction. Gross domestic product rises by as much as if government spending had been cut to make way for added investment. However, in the case of borrowing, either the additional capital is financed by foreign savers, or the added government debt is foreign owned, freeing up U.S. saving to pay for the investment. Either way, foreign savers are entitled to the interest or dividend payments, which absorb the added GDP made possible by the added capital. Consequently, gross national product and total income accruing to U.S. residents is lower in the case where foreigners own the additional capital.



Charts 5 and 6. Chart 5 shows the additional jobs created in the strong, weak, and investment incentive cases, assuming spending reductions cover the transition cost. Long term, an additional 4 million to 7 million jobs could be created. Chart 6 shows ultimate increase of 6 percent to 10 percent in the average real after-tax wage in the three cases, again assuming spending cuts.

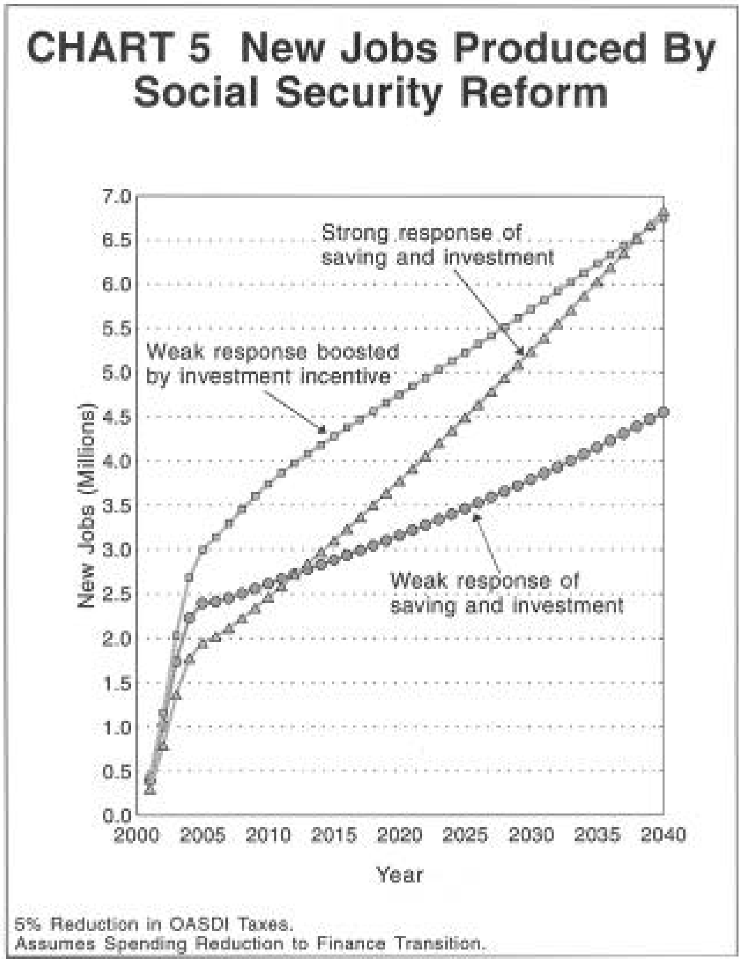
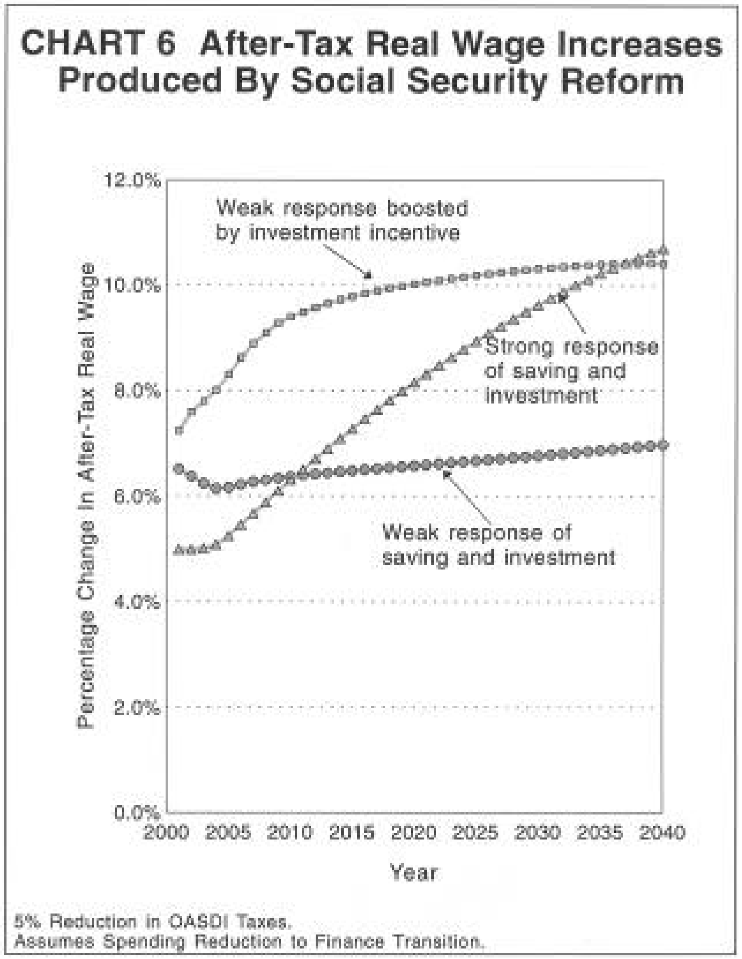


CHART 5 New Jobs Produced By Social Security Reform
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
New Jobs (Millions)
2000
2005
2010
2015
2020
2025
2030
2035
2040
Year
Strong response of saving and investment
Weak response boosted by investment incentive
Weak response of saving and investment
5% Reduction in OASDI Taxes.
Assumes Spending Reduction to Finance Transition.



CONCLUSION

The transition to a better retirement income system will take some effort, but the benefits are well worth it. Done right, reform could boost real after-tax wages by 6 percent to 10 percent, and create an additional 4 to 7 million jobs. Retirement income would be significantly larger than under current law.

For maximum economic benefits, the reform effort must increase the reward to labor. Increased work incentives depend on the reform's allowing a "carve-out" rather than an "add-on" approach to obtaining money for the required saving accounts. Workers must have real ownership of their retirement savings, and the flexibility to use it as they see fit.

Care must be taken to finance the transition to the new system without damaging the economy. One cannot count on economic growth to make the transition painless. There will be a need for substantial restraint in the growth of Federal spending. Additional Federal borrowing should be avoided as much as possible, although there is no need to repay large amounts of existing debt.

To encourage a net increase in saving, the individual saving accounts and other retirement saving should receive one or another type of IRA or pension tax treatment. Tax increases must be avoided. To ensure a substantial increase in domestic investment, depreciation should be replaced with immediate expensing of investment outlays, or, at the very least, asset lives should be shortened.

If these steps were taken, future generations would enjoy significantly higher incomes and lower taxes during their working years and in retirement.

Mr. SMITH. Dr. Reischauer.

STATEMENT OF ROBERT D. REISCHAUER, THE BROOKINGS INSTITUTION

Mr. REISCHAUER. Mr. Chairman, let me start by applauding the leadership and the focus that you have provided to this issue over the last several years. While I do not always agree with your policy prescriptions, I really do applaud the courage that you have shown.

I also want to congratulate this Task Force for providing free lunch to witnesses. I think in a way, for me anyway, this is a payback for the many times I sat in this chair or at the Ways and Means Committee when I was invited to testify at 11 and it would stretch on to 1, 2, and 3. The Members would slip out one by one to get something to eat and to go to the bathroom and the witness would be tied to the chair.

Mr. SMITH. As an economist, you know there is no such thing as a free lunch, we are expecting magnaminous testimony.

Mr. REISCHAUER. Well, I figured a privatizer like Steve would be picking up the tab in the end, so I had no qualms about this at all.

I was asked to say a few words about the criteria for evaluating proposals to reform Social Security and I have listed them on the handout that you have. In deciding which one or two are the most important, I think it is worth reflecting on the primary reason why the Nation established a mandatory pension system back in 1935. The reason was the belief that, left to their own devices, many workers would not save sufficient amounts to support themselves and their dependents when they could not longer work. People tend to be myopic. They focus on immediate needs and those crowd out their long run needs.

In addition, there are those whose earnings are so low or so unstable that even if they did salt away what any reasonable person might think was a pretty hefty proportion of their incomes each year for retirement, the amount that they would have accumulated by the time they turned 65 would not be sufficient to purchase an annuity of an adequate size.

Of course, we could, as Steve has suggested, just decide that those who are myopic or those who tried, but failed to save enough for retirement, be picked up by the welfare system—SSI, Food Stamps, whatever—but as a society, we decided back in 1935, and have reinforced this decision several times through history, that that would create a moral hazard for many low wage workers and would be demeaning to many who had spent all of their working lives as independent individuals and then were forced into a position of dependency.

When you consider these roots of Social Security, I think the most important dimension on which reform proposals should be evaluated relates to benefits. Are they adequate? Are they stable and predictable? Retirees have little ability to cope with unexpected fluctuations in their incomes. They need protection against market risks. They need protection against unanticipated inflation. They need protection against living a long and healthy life.

Is the distribution of benefits fair? Fair, of course, is in the eye of the beholder, but generally, our society has viewed that basic retirement income should be more evenly distributed than earnings are and that those basic retirement incomes should provide some protection for widows and widowers and divorcees and others.

The second criterion that is worth focusing on deals with the equitable distribution of risk. Any long term contract inevitably involves risk and the question is who is going to bear that risk? Is it going to be individuals or society? Of course, society is made up of individuals and one has to ask if society bears that risk, is it tax payers? Is it beneficiaries? Is it workers or general taxpayers or both? When something unexpected happens, the consequences have to be absorbed by some group or some individuals and the question you want to ask when you look at these reforms is who is bearing that burden? Is it spread out over time or concentrated in a short period of time?

A third criterion is the return on contributions. Is it fair? To the extent that contributions exceed the amount that we need to pay for benefits of current retirees, we would want those contributions to be receiving a fair or a market rate of return. That is not the case with the current system and that is why some of us have suggested a more diversified portfolio of assets for the Social Security Trust Fund and why others believe that Individual Accounts are an appropriate way to go.

Fourth, administrative efficiency, simplicity and ease of compliance. We have a system now which is very efficient. It is worth reflecting when we think about changing that system how much additional administrative costs are going to be imposed. Virtually all of the proposals that have been put forward keep the Survivors Insurance system. They keep the Disability Insurance system and they often provide some scaled back Social Security benefit or a flat benefit of some kind. As long as we keep SI and DI in existence, we are going to have virtually all of the administrative costs of the existing system, so any change we adopt, no matter how efficient it is, is going to add to the cost of running our overall retirement system.

What about with respect to employers? All of these systems, and the current one, impose costs on employers. A lot of the discussion often seems to assume that all employers are sophisticated and computerized, but that is not the case. We have to design a system not for IBM, not for the Federal Government personnel system, but for the real world. And in the real world, 5.4 of the 6.5 million employers do not have computerized payroll systems. There are lots of mistakes made even in the very simple system that we have now 11 million W-2s do not match Social Security Administration records. Four and a half million of these discrepancies, after months of working on them, remain unresolved; 500,000 employers send in their W-3s late, send them in unreadable states or do not send them in at all. You want to ask is the system that you are considering capable of dealing with a world like that? And often the answer is no.

With respect to participants, it is worth noting that we are not designing the system for people such as ourselves, people who are interested in investments, people who are sophisticated, know how to use information. Instead, we are designing one that can work for the 27-year-old male who has three jobs during the year in different parts of the country; the individual who maybe has several marriages during his life, has different dependents resulting from these marriages, and so on. We want to design a system that can work for the bottom 30 percent. If we were worried about people like ourselves, we really probably would not have the mandatory retirement pension system that we have right now.

Political sustainability. Continuity is important. You do not want a mandatory retirement pension system that is in constant flux. That is not an endorsement of rigidity. We probably have had a system that has been too rigid over the last 65 years. One that has not changed itself to reflect the very profound social, economic and demographic changes that this country has experienced since 1935. But we do want a structure that is inherently stable and one that does not set up dynamics for changes that we would not approve of.

Let me give an illustration of this. Think of a system with individual personal accounts with private ownership. Will we be able to ensure that the savings that are built up in those accounts are there when people retire? You will be under tremendous political pressure, I think, to let people dip into their accounts for worthwhile purposes. For example, if the individual is sick and cannot receive adequate medical attention, are you going to deny them the ability to use the resources? Probably not. And, as taken place with the IRAs, the system will begin to unravel.

Finally, the macroeconomic——

Mr. SMITH. Dr. Reischauer, I am going to ask you to sort of wrap it up.

Mr. REISCHAUER. OK. There is the macroeconomic dimension. Here, we want to insure that whatever reform we adopt adds to national saving and economic growth and does not discourage the labor of forced participation of those who are beyond the retirement age or reduce the work effort of those who are below the retirement age.

[A chapter submitted from Dr. Reischauer's book, "Countdown to Reform," follows:]

7

PROPOSALS TO REFORM SOCIAL SECURITY: A REPORT CARD

Policy makers and the public face a bewildering array of proposals to reform or replace Social Security. Members of Congress, business organizations, academicians, and think tanks have produced dozens of proposals. The 1994–96 Advisory Council on Social Security alone developed three different plans, none of which won majority support.

Fortunately for the interested citizen, almost all proposals fall into one of three categories: plans to replace the current system entirely with private accounts, plans to replace the current system partly with private accounts, or plans to strengthen and modernize the current system. There are two other approaches to Social Security reform—making retirement saving strictly voluntary and imposing means or income tests as a condition for benefits—but few have developed detailed plans along such lines. Moreover, for the reasons we describe in Boxes 3–6 and 7–1 (see page 118), we consider these approaches both ill considered and unworkable.

In this chapter, we propose four criteria for evaluating reform plans. We apply these criteria to several plans that exemplify the three major approaches to reform and grade these plans from A to D.[1] We give no plan a failing grade of F because all would restore financial balance to the nation's basic retirement system. A grade of D means

Box 7–1
Why Means Testing of Social Security Doesn't Make Sense

Peter G. Peterson, former secretary of Commerce, has proposed that all federal benefits to individuals, including Social Security and Medicare, be subject to an affluence test.[a] Under this plan, which has been endorsed by the Concord Coalition, households with incomes at least $5,000 over the national median would have their benefits scaled back 1 percent for each $1,000 by which their annual income including benefits exceeded the threshold. In other words, a household with an income $30,000 above the threshold would have its benefits scaled back 30 percent. The maximum amount by which benefits could be reduced would be 85 percent.

This approach seeks to lower benefits most for those who need them least. This same principle is reflected in the current Social Security benefit formula, which provides higher replacement rates for workers with low average earnings than for workers with high average earnings. It also is the logic behind the progressive income tax.

Unfortunately, this principle would have undesirable consequences if applied to Social Security benefits. It would increase penalties on work and saving, raise insurmountable administrative problems, and undermine the basic rationale of Social Security.

To see how the affluence test would work if applied to income—and the problems it would generate—consider a retired wife receiving $10,000 a year in Social Security and her working husband who earns $30,000 a year. They also receive $25,000 in income from their investments. Given median income of $32,000 in 1997, the affluence test would reduce the retiree's Social Security by $2,800. If the retiree's husband stopped working, she would not suffer this benefit reduction. They could also avoid the affluence test in whole or in part if they shifted their investments into assets that generated little income, but promised subsequent capital gains.

These responses, which would undermine the intent of an income test, could be minimized if the test were applied to net worth, rather than annual income. Unfortunately, net worth tests are even more costly to administer than income tests, as they require annual valuations of all assets, many of which are not generally traded. Furthermore, asset tests are easily evaded now that the financial market is global.

An income test violates the fundamental political compact that underlies Social Security—that a lifetime of work in jobs requiring payment of the payroll tax entitles a worker to a benefit based on average earnings when that worker reaches retirement age. Without this principle, there would be no rationale for financing benefits with a payroll tax or relating benefits to past earnings. An income test upsets this principle by denying benefits, regardless of earnings or payroll taxes paid, to people who saved a lot, had earnings, were lucky in investments, or were blessed by significant inheritance. The principle of relating benefits to past earnings is not sacrosanct. But introducing an income or asset test would erode the political basis for payroll tax-supported social insurance.

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a. Peter G. Peterson, *Will America Grow Up Before It Grows Old?* (New York: Random House, 1996), and *Facing Up: How to Rescue the Economy from Crushing Debt and Restore the American Dream* (New York: Simon and Schuster, 1993).

that we regard a plan as so severely flawed that it does not merit serious consideration. A grade of C means that a plan contains major shortcomings according to the criteria we propose. A grade of B means that a plan has significant strengths and meets most requirements for reform, but comes up short in one or more key respects. The grade of A means that a plan meets all major requirements for reform and falls seriously short in none. Not everyone will agree with our evaluations. Some may object to the particular criteria we have selected or the importance we attach to them. Others may think we have been too harsh or lenient in grading a particular plan. In the end, you must form your own judgment.

Criteria for Reform

Our first criterion requires that a good reform plan ensure *adequate* benefits that are *equitably* distributed and represent a *fair return* for taxes paid. Current benefits are not unduly generous, as we showed in Box 6–1. For that reason, *adequacy* means that large benefit cuts are unacceptable because they would result in insufficient protection for retirees, the disabled, and survivors. Overall benefit increases are also undesirable because they would further swell the added costs the retiring baby boomers will generate. *Equity* requires that protection be maintained for low earners, large families, and other vulnerable people. And a *fair return* means that plans should be invested wisely and not incur needless administrative costs.

Our second criterion is that the unavoidable *risks of long-term pension commitments should be shared broadly*, not placed on the shoulders of individual workers. Our third criterion for judging plans is *administrative efficiency and feasibility*. In addition to avoiding needless administrative costs, the plan should not be unduly complex for private businesses, workers, and the government. Finally, we give higher grades to plans that *raise national saving*. A plan's contribution to national saving is determined by its additions to reserves held in either the trust funds or individual accounts, less any induced reductions that take place in private saving or government surpluses outside the retirement system.

Other consequences of Social Security reform are also important. How reform will influence retirement decisions, for example, will be of increasing importance as labor force growth slows to a crawl during the first decades of the twenty-first century. Reform may also change the relative treatment of one- and two-earner couples, a subject of particular concern to the growing number of working women. While these—and many other—dimensions of reform are of concern, no plan that provides inadequate benefits, fails to protect low earners, and gives a poor return for each dollar of taxes paid; that subjects workers to excessive risk; that generates needless administrative complexity; and that does nothing to boost national saving should merit serious consideration. (See the appendix to this chapter, page 141, and Table 7–1, for some specifics about the major plans.)

Proposals to Replace Social Security

Several plans would replace Social Security with a wholly new system based on personal retirement accounts. The plans differ in how much assistance they would give low earners beyond the accumulation in each worker's personal account, how much discretion individuals would have to select investments for their accounts, how much control participants would have over the way benefits are paid from their personal accounts when they retire, how much risk individual workers would face, how the plans would be administered, and how the costs of transition to the new system would be paid for.

Personal Security Account Plan

The Personal Security Account plan, advanced by five members of the 1994–96 Advisory Council on Social Security, would gradually replace Social Security with two other benefits, one based on balances accumulated in mandated IRA-like personal retirement accounts, the other a flat annuity based on how long the recipient had worked and the age at which benefits were first received.

The plan would be phased in over many years. Workers under age 25 when the new plan came into effect would receive benefits only under the new system. Workers between the ages of 25 and 55 would receive a blend of benefits under the new and old systems. Retirees and workers over age 55 would remain under the current

Table 7–1

Policies to Reform Social Security and Reduce the Long-term Deficit Contained in Seven Social Security Reform Plans

	Personal Security Account	Feldstein	Individual Account	Moynihan	Breaux-Gregg	Ball	Maintain Structure
Benefit Reductions							
1. Accelerate to 2011 the scheduled increase to 67 in age at which unreduced benefits are available	X		X	X	X		X
2. Increase age at which unreduced benefits are available to 68 by 2017 (*to 70 by 2029)				X	X*		
3. After 1 or 2 above, increase age at which unreduced benefits are available to keep the fraction of adult life in retirement constant (*by one month every two years,** by one month every year and a half)	X		X	X*	X**		X
4. Increase age of initial eligibility along with age at which unreduced benefits are available	X				X		X
5. Reduce spouse's benefit to one-third of worker's benefit			X		X		X
6. Average earnings over thirty-eight (*forty years) rather than thirty-five years when computing benefits			X	X	X*	X	X
7. Reduce replacement rate for those with higher average earnings			X		X		
8. Reduce disability benefits	X		X		X		
9. Reduce annual cost-of-living adjustment				X	X		

Continued on next page

Table 7–1 (Cont'd.)

	Personal Security Account	Feldstein	Individual Account	Moynihan	Breaux-Gregg	Ball	Maintain Structure
Benefit Enhancements							
10. Eliminate earnings test (* at the normal retirement age)	X			X	X*		
11. Raise benefits for surviving spouse to 75 percent of the couple's combined benefit			X				X
12. Ease disability requirements for those affected by the increase in the age of initial benefit eligibility							X
Revenue Increases							
13. Subject more of benefits to the income tax	X		X	X		X	X
14. Raise payroll tax rates (*lower rates initially followed by higher rates)	X		X	X*			
15. Raise maximum earnings subject to payroll tax				X		X	
16. Borrow from the public or channel general revenues into retirement accounts	X	X			X		
Other							
17. Establish individual retirement accounts (* voluntary)	X	X	X	X*	X		
18. Require all new state and local employees to join Social Security	X		X	X	X	X	X
19. Establish minimum non-earnings-related benefit	X				X		
20. Invest the trust funds' reserves in private, as well as government assets						X	X

Social Security system. No retiree would receive benefits entirely under the new system for about forty years. Payroll tax rates would be increased 1.52 percentage points until virtually all adults now alive are either dead or retired—that is, for about seven decades, a period the architects designate "the transition." The added tax is needed because continued Social Security benefits for current retirees and older workers, the new flat pension, and deposits into personal accounts would cost more than the current 12.4 percent payroll tax will generate. Even with the tax increase, the new system would run a deficit for the first few decades, forcing the government to borrow approximately $2 trillion (in 1998 dollars). Eventually, as Social Security phases out, revenues would exceed costs and the debt would be paid off. When all the initial borrowing had been repaid—around the year 2070—the supplemental payroll tax could be repealed.

The Personal Security Account plan has other important implications. The first-tier flat benefit would guarantee inflation-protected payments until the worker and his or her spouse died. The second-tier benefit would not provide protection against inflation or a long life unless the worker chose to purchase an inflation-indexed annuity with his or her personal account balance. All of the flat benefit, but none of the pension provided from the personal accounts, would be included in income subject to the income tax. Relative to current rules, this feature would raise taxes on low- and moderate-income retirees and decrease them on higher-income retirees. The Personal Security Account plan would retain the disability insurance program but would gradually cut benefits. Furthermore, the disabled would not have access to their personal retirement account until they reach retirement age. Even then, the balances of those who became disabled when young and made deposits for only a few years would be small. Workers would enjoy control over investment and withdrawal of their retirement funds, but would sacrifice reliability and face sharply higher administrative costs.

Benefit Adequacy and Equity. While the plan promises good benefits for retirees on the average, it provides poor protection to certain vulnerable groups. It cuts disability benefits as much as 30 percent. Divorcees who earned little during their married years, possibly because they were busy raising children, could find themselves with little more than the flat benefit. Because the Personal Security

Account plan would permit workers to invest their individual accounts in quite different portfolios, some workers would do poorly and, therefore, have to depend on the flat benefit for the bulk of their retirement income.

Protection against Risk. The pension provided through the flat benefit—an inflation-adjusted annuity—would provide reliable protection against risk. That derived from the personal accounts, however, would expose retirees to considerable uncertainty. Pensions for workers with similar earnings would vary widely because returns on personal accounts would depend on how funds were invested, what administrative fees were imposed by fund managers, how high asset values were when balances were withdrawn, and whether pensioners bought annuities when they retired. Those who invested unwisely, had bad luck, or spent their accumulated savings too fast could find themselves dependent, in their later years, on the plan's flat benefit.

Administrative Efficiency. The Personal Security Account plan does poorly on this criterion. The administrative structure for the current Social Security system would have to be maintained for many years. In addition, the tax collection and record-keeping systems needed for payment of survivor and disability benefits would continue and a simplified system would have to be established to administer the flat benefit. Another new structure would be required to ensure that employers made timely and accurate deposits into personal accounts and that the financial institutions managing personal accounts complied with the inevitable regulations. The administrative burdens imposed on small employers would be so burdensome that we doubt that the plan could actually function as envisioned. Even large employers would find it onerous to direct periodic deposits—many of which would be less than $100 a month—to the numerous fund managers chosen by their employees.

On average, workers would face dramatically higher administrative costs that would seriously lower the net returns to workers, compared to plans that managed similar investments centrally. Since some of these costs do not vary with the size of accounts, they would represent a larger portion of income of small accounts than on large accounts.[2] Furthermore, those pensioners who wished to buy annuities would face large additional costs.

National Saving. The Personal Security Account plan ranks relatively high on adding to national saving because it raises payroll taxes. However, the personal accounts would be so similar to existing IRAs and 401(k) plans that workers would probably reduce other private saving more than if the accounts were held and managed centrally by the government. Furthermore, if experience with IRAs is any indication, Congress would come under pressure to allow withdrawals from personal accounts for specified meritorious uses well before retirement. Such withdrawals would reduce the resources available to support retirement pensions and any positive effect on national saving. A similar problem would arise with all individual account plans, but it is most serious for plans that set up accounts similar to current tax-sheltered savings arrangements.

Overall, we give the Personal Security Account plan a grade of C (see Table 7–2).

TABLE 7–2
REPORT CARD FOR THE
PERSONAL SECURITY ACCOUNT PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	C+
Protection against risk	C
Administrative efficiency	D
Increased national saving	B
Overall grade	C

FELDSTEIN PLAN

Under a plan crafted by Martin Feldstein, professor of economics at Harvard University and a former chairman of the Council of Economic Advisers, each worker would deposit 2 percent of his or her earnings, up to the maximum subject to the payroll tax, in a personal retirement account.[3] Workers would receive an income tax credit sufficient to offset the cost of these deposits. For those with no tax liability or liabilities less than 2 percent of earnings, the tax credit would be refundable. For as long as they last, the projected budget surpluses would be used to finance the tax credits. Increased federal borrowing, tax increases, or spending cuts would then be required for a number of years.

The personal retirement accounts, which would represent a massive infusion of new resources into the mandatory retirement system, would be invested in regulated stock and bond funds chosen by the worker and administered by private fund managers. When workers reached retirement age and began to draw pensions from their personal retirement accounts, their Social Security benefits would be reduced by $3 for every $4 withdrawn. In effect, the benefits promised by the current Social Security program would become a floor under pensions. Overall, retirees would receive an estimated 60 percent of their benefits from Social Security and 40 percent from their personal accounts. Higher earners would depend more on their personal accounts than these averages suggest, and some would receive nothing from Social Security. The reductions in Social Security benefits would eventually be sufficient to close the projected long-term Social Security deficit.

Benefit Adequacy and Equity. This plan would raise, not lower, the baby boomers' pensions. Given widespread concern about the projected costs of supporting pension and medical benefits for the elderly and disabled, we regard proposals to raise benefits as imprudent. The Feldstein plan would provide larger retirement benefits than those of any other plan we examine, larger in fact than those promised by the current Social Security system. More generous benefits are possible because the plan uses the budget surpluses projected for the next two decades to support deposits into individual accounts.[4] When these surpluses begin to shrink, taxes dedicated to retirement pensions will have to be raised, other spending cut, or deficits incurred for several decades.

The benefit increases would be inequitably distributed. Benefits would rise proportionately more for high earners than for low earners. The contribution to individual accounts and, hence, the size of account balances would be a constant fraction of income. Social Security benefits are proportionately larger for low earners than for high earners. Since the plan would reduce Social Security benefits by three-quarters of any benefits derived from individual accounts, pensions for high earners would rise proportionately more than would pensions of low earners. The following simple numerical example, which is presented in monthly amounts, illustrates this point.

	Average Earnings	Social Security	Individual Account	Total Pension	Change in Pension
Low Earner	$1,000	$560	$240	$620	+11%
High Earner	$5,600	$1,375	$1,340	$1,720	+25%

The Social Security benefits in the table correspond approximately to the replacement rates of low and maximum earners—56 percent and 25 percent respectively. Each worker contributes proportionately to individual accounts and, therefore, receives a pension proportionate to earnings. When Social Security benefits are reduced by three-quarters of the pension based on the individual account, the low earner's total pension goes up 11 percent, the high earner's by 25 percent. Since high earners are likely to select higher-yielding, albeit riskier, portfolios, the increase in benefits for higher earners relative to that for low earners is likely to be even larger than this illustration shows. In short, high earners would tend to receive little from Social Security and, in the extreme case, might receive nothing.

Protection against Risk. At the level of the individual pensioner, the Feldstein plan provides substantial protection against market risk because it guarantees participants a pension at least as large as that promised by the current benefit formula. However, the plan is likely to undermine political support for a defined-benefit guarantee like Social Security among high and moderate earners because most of them would eventually receive pensions based predominantly on their personal accounts. We explore this issue in more detail in the next chapter. Furthermore, the plan poses major fiscal risks because the commitment to increased pensions would generate severe budget pressures, particularly after currently projected budget surpluses end. The fiscal duress would affect all government spending and taxes.

Administrative Efficiency. The Feldstein plan would be complex and costly to administer. As was true with the Personal Security Account plan, administrative and investment management fees will eat into returns on personal retirement account balances. The IRS would face numerous problems when it tried to refund the tax credit to those with no or limited tax liabilities. Nor would it be easy for the Social Security Administration to design and operate a system that reduced Social Security benefits by $3 for every $4 withdrawn from each retiree's personal account.[5]

National Saving. The effects of the Feldstein plan on national saving are complicated and unclear.[6] Initially, the plan would not affect saving at all, as the deposits in individual accounts would simply substitute for the reduction in federal debt that will occur if the projected budget surpluses are not dissipated through tax cuts or spending increases. The longer-run effects on saving depend on how successive Congresses and presidents react when the surpluses are no longer large enough to sustain the required deposits into the individual accounts and on the extent to which individuals cut back on other saving to offset mandatory saving in individual accounts.

The Feldstein plan deserves the same overall grade that was given to the Personal Security Account plan (see Table 7–3).

TABLE 7–3
REPORT CARD FOR THE FELDSTEIN PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	B+
Protection against risk	B-
Administrative efficiency	D-
Increased national saving	D
Overall grade	C

REDUCE SOCIAL SECURITY AND SUPPLEMENT IT WITH SMALL PERSONAL ACCOUNTS

Another group of proposals would supplement a reduced Social Security system with small defined-contribution personal retirement accounts. These plans would scale back defined-benefit Social Security pensions by different amounts and in different ways, and would create personal retirement accounts of various sizes and forms.

Individual Account Plan

The Individual Account plan, crafted by Edward M. Gramlich, chairman of the 1994–96 Advisory Council on Social Security, would cut back Social Security outlays sufficiently so that the current 12.4 percent payroll tax would cover future program costs. Benefits relative to those promised under current law would be cut gradually—by little for low earners and up to more than 25 percent for high earners (see the appendix to this chapter, pages 142–43, and Table 7-1 for details). An increase in the *employee* payroll tax by 1.6 percentage points would finance small personal retirement accounts invested in a restricted number of index mutual funds managed by a government agency. Balances would be converted into inflation-protected annuities when workers reach retirement age.

The annuities would be small. A worker with median covered earnings who was 40 years old when the plan was implemented would receive an annuity of about $125 (in 1998 dollars) a month starting at age 65, which would equal about 13 percent of the worker's expected Social Security benefit under the current system.[7] Older workers, who would start contributing at a later age, would contribute for fewer years and would receive less; younger workers would participate for more years and receive larger pensions. Because payroll taxes would fully finance the new individual accounts, the plan would require no other transitional taxes or borrowing. However, the Individual Account plan would cut disability benefits by varying amounts depending on earnings. As with the Personal Security Account plan, individual accounts can do nothing to offset these cuts until the disabled reach retirement age, and not much even then for workers who become disabled when young.

Benefit Adequacy and Equity. Despite its name, the Individual Account plan would continue to rely heavily on Social Security, although benefits provided through that program would ultimately be cut by over 25 percent for high earners. On the average, pensions financed by individual accounts would fill in this gap for people of retirement age. But the disabled would suffer reduced benefits until they reached retirement age. The cuts in the defined-benefit component of the reformed system are larger than necessary because the Individual Account plan would continue to prohibit managers of the Social Security trust funds from investing in a diversified portfolio. The adequacy of pensions based on individual accounts would vary among workers of a given age and over time, depending on their choice of index funds and market performance.

Protection against Risk. The individual accounts would be subject to market risk, but the variation would be less than that of the Personal Security Account and Feldstein plans because investments would be limited to a few centrally managed index funds. The pensions based on personal retirement accounts would never constitute more than a modest portion of future retirees' pensions—about 30 percent of the benefits for an average wage worker and 20 percent of those for a low earner. Both the pension provided through the scaled-back Social Security and that provided from the individual account would be inflation-protected annuities.

Administrative Efficiency. Administrative costs for the Individual Account plan would be somewhat higher than those under Social Security. Central administration, mandatory annuitization, and the limited number of indexed investments would hold down costs. But the federal government would have to establish arrangements for depositing funds in accounts of each worker's choice, educating them about the options, and responding to questions. It would also have to keep track of divorces if funds accumulated in personal accounts were divided at divorce, an important protection for lesser earners, usually wives, and an issue facing all plans with individual accounts.

National Saving. The increased payroll tax and the benefit cuts would both raise national saving. Workers would probably reduce their private saving less per dollar in their individual account than they would under the Personal Security Account and Feldstein plans because these centrally held accounts would not be viewed as good substitutes for IRAs or 401(k) plans, from which withdrawals under certain circumstances are permitted.

We give the Individual Account plan a solid B for an overall grade (see Table 7–4).

TABLE 7–4
REPORT CARD FOR THE
INDIVIDUAL ACCOUNT PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	B
Protection against risk	B
Administrative efficiency	B-
Increased national saving	B+
Overall grade	B

MOYNIHAN (SOCIAL SECURITY SOLVENCY) PLAN

Senator Daniel Patrick Moynihan (Democrat of New York) proposes to cut payroll taxes, substantially lower Social Security benefits, and *authorize* workers to set up individual accounts. Payroll taxes would be cut 2 percentage points until 2025—1 percentage point for workers and 1 percentage point for employers (see the appendix to this chapter, page 145, and Table 7–1 for details). Workers would be permitted to spend or save the 1 percentage point cut in their portion of the payroll tax. They could save it either in voluntary personal accounts modeled on the Thrift Savings Plan and administered by a new government board or in special Individual Retirement Accounts managed by financial institutions of their choosing. If an employee established a personal account, the worker's employer would have to match the worker's contribution. Withdrawal of account balances at retirement would be unrestricted.

From 2025 to 2060, the payroll tax rate would be raised periodically to keep program revenues in line with benefit payments. After 2045, the combination of payroll taxes and deposits in personal accounts would exceed the current payroll tax rate. In 2060, the 13.4 percent payroll tax rate together with contributions to a personal account would claim 15.4 percent of covered earnings, 3 percentage points above the current payroll tax.

Because the Moynihan proposal would cut average payroll tax collections over the next 75 years, it would have to cut Social Security benefits more than would be necessary if taxes were maintained. Retirement, survivor, and disability benefits would be cut by an average of about 20 percent relative to current law, but the cuts would grow over time and be larger for the long-term disabled and the very old than for those who are just beginning to receive benefits. The cuts result from holding annual inflation adjustments 1 percentage point below the CPI and by cutting benefits across the board through increasing the age at which unreduced benefits are paid. Over time, the Moynihan plan would return Social Security to a pay-as-you-go system, with reserves sufficient to tide the system over a severe economic downturn.

The Moynihan plan would deny full inflation adjustments under the personal income tax and under all indexed benefit programs except Supplemental Security Income. Over time, this would cause massive increases in income tax burdens and reductions in entitlement spending for benefits for veterans, civil servants, and others.

Benefit Adequacy and Equity. This plan would erode benefits steeply and in ways that could hurt vulnerable groups the most. Those who received benefits the longest—the very old and the long-term disabled—would suffer the largest benefit reductions from the cumulative effects of the 1 percentage point reduction in the annual cost-of-living adjustment. In 2017 when the age at which unreduced benefits are paid would reach 68 under this plan, benefits for a 62-year-old retiree will be 35 percent smaller than those available at age 68. Hardship among the very old, especially widows and widowers, could increase if many are encouraged by the elimination of the earnings test for early retirees to draw these greatly reduced benefits at age 62 or 63, supplementing them with earnings while still in their 60s. When such early retirees reach their mid-70s and find even part-time work burdensome, the reduced benefits may prove inadequate, particularly for low earners, the group least likely to have set up voluntary investment accounts. The less-than-complete adjustment for inflation would only compound their difficulty.

Protection against Risk. Because workers could invest their voluntary accounts in a wide range of assets, they would be exposed to a good deal of investment risk. Social Security would provide only partial protection against inflation, and pensions derived from the voluntary accounts would have none. With no restrictions on when or how retirees could convert their account balances into retirement income, some could outlive these pensions.

Administrative Efficiency. Government administrative costs would rise because it would be necessary not only to retain the Social Security

Administration in full, but also to create a wholly new government-managed individual account system and to ensure compliance for privately managed accounts. Small and medium-sized businesses would face virtually insurmountable challenges in trying to make the program work. They would have to keep track, pay period by pay period, of whether workers (including new hires and departing workers) wanted to contribute to individual accounts or not; whether those who made contributions wanted their funds deposited in the government-managed program or in a privately administered account; and, for those who chose private accounts, which of the many thousands of private fund managers that would be vying for business the worker had selected.

National Saving. If all of its provisions remained in force, the Moynihan plan would raise national saving even though it would return to pay-as-you-go financing of Social Security. One explanation for this is that income tax collections would rise dramatically, the inevitable consequence of not indexing the tax brackets, exemptions, and the standard deduction. Another is that the growth of mandatory spending would slow because the plan would deny full inflation adjustments under all indexed benefit programs except Supplemental Security Income. If, as we think highly probable, Congress acted to preserve full inflation adjustments for the income tax system and key benefit programs, the plan would reduce national saving.

The Social Security Solvency plan developed by Senator Moynihan is inadequate and merits an overall grade no higher than a D (see Table 7–5).

TABLE 7–5
REPORT CARD FOR THE MOYNIHAN (SOCIAL SECURITY SOLVENCY) PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	F
Protection against risk	C+
Administrative efficiency	D-
Increased national saving	D
Overall grade	D

Breaux-Gregg (Twenty-first Century Retirement) Plan

The plan proposed by Senators John Breaux (Democrat of Louisiana), Judd Gregg (Republican of New Hampshire), and others would divert 2 percentage points of the current payroll tax to individual accounts modeled on the Thrift Savings Plan and cut Social Security benefits an average of 25 to 30 percent (see the appendix to this chapter, page 146, and Table 7–1 for details).[8] Cuts of this size would be necessary both to close the current projected long-term deficit and to free up 2 percentage points of the payroll tax for individual savings accounts. Retiring workers would be required to convert a portion of their account balances into an inflation-protected annuity. Together with the retiree's reduced Social Security benefit, this annuity would have to be sufficient to meet a standard for minimum retirement income.

Social Security benefits would be cut in four ways: by increasing the age at which unreduced benefits are available to 70 by 2029 and at a slower pace thereafter, by reducing the spouse's benefit, by shaving the cost-of-living adjustment, and by cutting replacement rates for all retirees except those with average earnings below approximately $5,700 in 1998, a threshold that would rise at the same rate as average earnings. A new minimum benefit would be established that was equal to 60 percent of the poverty threshold for those with twenty years of covered earnings, rising to 100 percent of the poverty threshold for those with forty years of earnings. A fail-safe mechanism would automatically keep the program in long-run balance and ensure that financial balance would not be jeopardized by unexpected developments.

Benefit Adequacy and Equity. The Breaux-Gregg plan, like the Individual Account plan, combines mandatory individual accounts, administered along the lines of the Thrift Savings Plan, with a scaled back Social Security system. The Breaux-Gregg plan, however, lowers both retirement and disability benefits more than the Individual Account plan does—30 to 40 percent for moderate and high earners. Larger cuts are necessary because the plan widens the program's deficit by diverting payroll taxes from Social Security, whereas the Individual Account plan raises payroll taxes to finance the personal accounts. As a consequence of these cuts, the assured element of pension protection would be drastically curtailed.

Protection against Risk. Because the investment options and management of the individual accounts would be patterned after those of the federal employees' Thrift Savings Plan, investment risk on these accounts would be moderate and similar to that of the Individual Account plan. The minimum Social Security benefit in the Breaux-Gregg plan, which is equal to the poverty threshold for a worker with forty years of participation, would provide some protection to low earners if returns from their individual accounts turned out to be sub-par. This safety net, however, would become less meaningful over time because productivity growth will push up real incomes while the poverty threshold is adjusted only for inflation. The minimum benefit could undermine political support for the system if many low and moderate earners received pensions based on the guaranteed minimum rather than on the Social Security benefit formula. This development would weaken the fundamental relationship between earnings and contributions on the one hand and benefits on the other. The mandatory annuitization of a portion of the personal accounts would protect people from outliving their pensions.

Administrative Efficiency. The central administration and investment management of the personal accounts, investment in a restricted number of index funds, and mandatory annuitization would hold down overhead costs of the Breaux-Gregg plan. These costs, however, would exceed those of the Individual Account plan because of the complexity inherent in calculating the portion of each personal account that would have to be annuitized and the difficulties associated with administering both the annuity and the remaining balance.

National Saving. Because it does not raise payroll taxes, the Breaux-Gregg plan would add much less in the near term to national saving than the Individual Account plan. Unlike the accounts under the Personal Security Account plan, those of the Breaux-Gregg plan would not be considered good substitutes for IRAs or 401(k) plans.

Overall, we give the Twenty-first Century Retirement plan sponsored by Senators Breaux and Gregg a grade of C+ (see Table 7–6).

TABLE 7–6
REPORT CARD FOR THE BREAUX-GREGG
(TWENTY-FIRST CENTURY RETIREMENT) PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	C
Protection against risk	C
Administrative efficiency	C+
Increased national saving	B-
Overall grade	C+

RETAIN SOCIAL SECURITY WITH CHANGES TO RESTORE FINANCIAL BALANCE

The final approach to Social Security reform preserves the current system and continues to rely on a defined-benefit system to assure basic retirement income. Mandatory pensions would remain tied exclusively to each worker's past earnings and years of work, not to fluctuating asset prices.

BALL PLAN[9]

Robert M. Ball, a former commissioner of the Social Security Administration, has proposed to restore projected long-run financial balance by increasing payroll tax revenues, cutting benefits modestly, and investing part of the trust funds' reserves in equities (see the appendix to this chapter, page 147, and Table 7–1 for details). Investment of up to 40 percent of the reserves in common stocks by 2015 would close roughly half of the projected long-term deficit. Increased revenues, which would come from subjecting a greater proportion of benefits to the personal income tax and increasing the maximum earnings subject to the payroll tax, would contribute another one-third. Extending coverage to newly hired state and local workers and increasing from 35 to 38 the number of years of earnings used to compute benefits finish the job.

Benefit Adequacy and Equity. The Ball plan would provide larger benefits than any of the other plans described in this chapter, save the Feldstein plan, which would appropriate projected budget surpluses and then raise taxes or cut other program spending to boost benefits. Vulnerable groups would be well protected. The plan, however, does not modify the spouse's or survivor's benefits or attempt to modernize Social Security in other ways to reflect the economic and social changes that have occurred over the past half century.

Protection against Risk. Because this plan would rely exclusively on defined-benefit pensions, it would spare workers exposure to the risks to their basic pension income that are inherent in individual accounts.[10] Annual cost-of-living adjustments would preserve the purchasing power of benefits from inflation. However, the Ball plan would probably not permanently solve the Social Security fiscal imbalance. Because the plan proposes only modest changes, Social Security would eventually fall out of close long-run actuarial balance, even if all economic and demographic assumptions prove accurate. Unpleasant surprises could cause deficits to appear sooner. While further adjustments to benefits or taxes could close any shortfall, we think current public distrust of the retirement system and of government in general make it vital to adopt reforms that will restore financial balance and sustain it even if economic and demographic assumptions turn out to be overly optimistic.

Administrative Efficiency. The Ball plan would maintain the current low-cost administrative structure for taxes and benefits. It would incur small added costs associated with investing the trust funds' reserves in equities but should amount to no more than 1/100 of a percent of funds invested.[11]

National Saving. Because the Ball plan would cut benefits and raise taxes only modestly, it would contribute less to national saving than several of the other plans.

Overall, the Ball plan deserves a strong B+ (see Table 7–7, page 138).

TABLE 7–7
REPORT CARD FOR THE BALL PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	A-
Protection against risk	B+
Administrative efficiency	A
Increased national saving	C+
Overall grade	B+

MAINTAIN STRUCTURE PLAN

The plan we described in Chapter 6 also relies exclusively on defined-benefit retirement pensions. The distinctive characteristic of this plan is the creation of a new Social Security Reserve Board (SSRB), modeled on the Federal Reserve Board, that would manage all financial operations of Social Security.[12] The operations of the Social Security system would be removed from the budget presentations of the executive and legislative branches. The SSRB would be charged with achieving, over the course of several decades, reserve balances similar in magnitude to those that would be required of private pension funds under the Employee Retirement Income Security Act. The trust funds' investments would be diversified among government bonds and private stocks and bonds. In addition, we propose somewhat larger benefit cuts than does the Ball plan to boost reserve accumulation and to raise national saving. The benefit cuts would be designed to reflect the changes that have occurred in the labor force and in life expectancy since the program was enacted.

Benefit Adequacy and Equity. This plan reduces benefits somewhat more than the Ball plan but it does not cut pensions significantly for vulnerable groups such as the disabled. Most surviving spouses would experience a small increase in benefits. Retired couples in which one spouse had little or no earnings history, on the other hand, would experience a modest decline in their pension. By investing the trust funds' reserves in a diversified portfolio, the plan would bring to people dependent on public pensions the higher yields that a broad portfolio of public and private bonds and stocks makes possible.

Protection against Risk. Like the Ball plan, the Maintain Structure plan preserves the key advantage of defined-benefit pension plans by spreading risks broadly among the general population. Benefits would remain fully protected from inflation. Because the plan more than closes the long-term deficit, uncertainty about future adjustment would be less than under the Ball plan. Furthermore, it incorporates a mechanism that would help to ensure that if the reformed program were to fall out of long-run actuarial balance in the future, policymakers would enact corrective measures.

Administrative Efficiency. This plan maintains all the administrative efficiencies of the current system.

National Saving. This plan would add moderately to national saving. It would isolate Social Security surpluses from the general budget process so that they are more likely than under current budget rules to add to national saving.

Nobody will be surprised if we award the plan we sketched out in Chapter 6 the top overall grade, an A- (see Table 7–8). That plan best meets the criteria we set forth earlier in this chapter.

TABLE 7–8
REPORT CARD FOR THE
MAINTAIN STRUCTURE PLAN

CRITERIA	GRADE
Adequacy, equity, and a fair return	B+
Protection against risk	A
Administrative efficiency	A
Increased national saving	B+
Overall grade	A-

Conclusion

No perfect way exists to reform the nation's mandatory retirement program; all plans involve tradeoffs among desirable objectives. Table 7–9 is our "grade sheet" for the seven plans. We did not give our plan a straight A because we think no plan that cuts benefits or raises taxes merits that grade. Furthermore, our plan—like all others—contains politically unpopular provisions that elected officials will find hard to endorse.

While investing Social Security's growing reserves, collectively or through individual accounts, in assets that have higher yields than government bonds can help, that policy change alone cannot close the projected deficit. To finish the job, future retirees will have to accept smaller benefits than those promised under current law or future workers will have to pay higher taxes. The weightlifter's maxim, "no pain, no gain," applies also to pension policy. The question is: Whose gain and whose pain?

Table 7–9
Summary Report Card

Plan	Grade
Personal Security Account	C
Feldstein	C
Individual Account	B
Moynihan	D
Breaux-Gregg	C+
Ball	B+
Maintain Structure	A-

Features of the Personal Security Account (PSA) Plan[a]

General Changes

- All newly hired state and local workers would be brought into the system.
- The retirement earnings test would be repealed.
- The scheduled increase to 67 in the age at which unreduced benefits are paid would be accelerated to 2011 and raised thereafter to reflect improved adult life expectancy.
- The age of initial benefit eligibility would be raised gradually from 62 to 64 by 2011.
- Disability benefits would be reduced gradually, for workers who are currently young, by up to 30 percent.
- Payroll taxes would be increased 1.52 percentage points for the next seventy-two years.

For Workers under Age 25

First Tier

- Workers with thirty-five or more years of covered employment would receive a flat, inflation-protected benefit equal to 76 percent of the benefit paid to low-wage workers under the current system. This benefit would be reduced 2 percent for each year of work under thirty-five years and by up to 30 percent if claimed earlier than the standard retirement age.
- Spouses with fewer than ten years of work would receive a flat benefit equal to half the benefit payable to the primary worker; widows and widowers would receive at least three-quarters of a couple's combined benefit.
- The flat benefit and spouse's, survivors, and disibility benefits would be financed by employers' payroll tax (6.2 percent of covered earnings) and 1.2 percentage points of the employees' payroll tax.
- All of the flat benefit would be subject to income tax.

Second Tier

- Personal Security Accounts would be established through a financial institution of the worker's choice. Five percentage points of the worker's earnings would be deposited in these accounts.
- Individuals could invest balances under rules similar to those governing Individual Retirement Accounts.
- At the age of initial eligibility for first tier benefits, each person could use the accumulated balance to buy an annuity, withdraw funds on a fixed schedule, or hold funds for transfer to heirs through bequest; all withdrawals would be exempt from income tax.

Continued on the following page

Features of the Personal Security Account (PSA) Plan[1] (cont'd)

For Workers Age 25 to 55

First Tier

- These workers would receive pensions from a blended system based mostly on Social Security for older workers and mostly on the First Tier of the new system for younger workers.

Second Tier

- These workers would have the same Personal Security Accounts as for younger workers, but smaller amounts would accumulate because deposits would have been made for a briefer period.

For Retirees and Workers Over Age 55

- These workers would receive Social Security, with general modifications listed above.

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a. *Report of the 1994–1996 Advisory Council on Social Security,* Volume I: Findings and Recommendations (Washington, D.C.: U.S. Government Printing Office, 1997).

Features of the Individual Accounts (IA) Plan[a]

Changes in Social Security

- Benefits would be reduced gradually for all newly retired workers with average adjusted lifetime earnings above about $5,724 (in 1998, and adjusted upward by the growth in average wages).
- The number of years of earnings used to compute benefits would be increased from thirty-five to thirty-eight.
- Social Security benefits would be taxed the same as contributory private pensions.
- All newly hired state and local workers would be brought into the system.
- The scheduled increase to 67 in the age at which unreduced benefits are paid would be accelerated to 2011 and raised thereafter to reflect improved adult life expectancy.
- The spouse's benefit would be cut from one-half to one-third of the primary worker's benefit, but surviving spouses would be assured a benefit equal to at least three-quarters of the couple's combined benefits.

Personal Accounts

- A new 1.6 percentage point payroll tax would be imposed on employees and its proceeds would be deposited in individual accounts that resembled the accounts held in the federal employees' Thrift Savings Plan (see Box 6–4).
- When workers retired, their account balances would have to be converted into inflation-protected annuities.

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a. *Report of the 1994–1996 Advisory Council on Social Security*, Volume I: Findings and Recommendations (Washington, D.C.: U.S. Government Printing Office, 1997).

Features of the Moynihan (Social Security Solvency) Plan[a]

Benefit Cuts

- The annual cost-of-living adjustment to benefits would be 1 percentage point less than the change in the Consumer Price Index.
- The age at which unreduced benefits are paid would be increased two months each year until it reached 68 in 2017, and by one month every two years thereafter until it reached 70 in 2065.
- The number of years of earnings used to calculate benefits would be increased gradually from thirty-five to thirty-eight.

Revenue Increases

- Benefits would be taxed in the same fashion as contributory private pensions.
- The maximum taxable earnings would be increased gradually by about 18 percent.

Other Changes

- The payroll tax rate would be cut by 2 percentage points and then raised gradually to support the system on a pay-as-you-go basis.
- Voluntary retirement savings accounts would be established for those workers who wanted to contribute 1 percent of earnings to them. Employers would have to match the employees' contributions. The worker could choose to have the account managed by the government's Voluntary Investment Fund Board, which would offer investments similar to those available to federal employees in the Thrift Savings Plan or by a private financial institution. Account balances could be withdrawn in any form upon retirement.
- All newly hired state and local workers would be brought into the system.
- The retirement earnings test would be repealed.

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a. S.1792, 105th Congress, 2d Session, and "Senator Daniel Patrick Moynihan Social Security Solvency Act of 1998, Brief Description of Provisions and Supplementary Materials from the Congressional Budget Office and the Social Security Administration," mimeo, March 1998.

Features of the Breaux-Gregg (Twenty-first Century Retirement) Plan[a]

Changes in Social Security

- The spouse's benefit would be gradually reduced from one-half to one-third of the primary worker's benefit.
- Benefits would be computed by summing all of a worker's adjusted earnings and dividing by forty.
- Benefits would be reduced gradually for all newly retired workers with average adjusted lifetime earnings above about $5,724 (in 1998 and adjusted upward by the growth in average wages).
- All newly hired state and local workers would be covered.
- The age at which unreduced benefits are paid would be increased two months a year, reaching age 70 in 2029, and by one month every year and a half thereafter, reaching 72 in 2065.
- The age of initial eligibility for benefits would be increased two months a year, reaching age 65 in 2029, and by one month every year and a half thereafter, reaching 67 in 2065.
- The retirement earnings test would be eliminated for all those above the age at which unreduced benefits are available.
- The early retirement penalty and the delayed retirement credit would be increased to make them more accurate.
- The annual cost-of-living adjustment would be reduced to account for a portion of the bias remaining in the measured CPI.

New Minimum Benefit

- A minimum benefit would be established equal to 60 percent of the poverty threshold for those with twenty years of covered earnings and rising by 2 percentage points per additional year to 100 percent of the poverty threshold for those with forty or more years of covered earnings.

Personal Accounts

- Personal accounts similar in investment options and management to accounts held in the federal employees' Thrift Savings Plan (see Box 6-4) would be established using 2 percentage points of the existing payroll tax. Supplemental voluntary contributions of up to $2,000 per year would be permitted.
- Upon retirement, a portion of the accounts' balances would have to be used to purchase an inflation-protected annuity that, when added to the scaled back Social Security benefit, met a minimum threshold for retirement income adequacy. Excess balances could be withdrawn according to the retiree's needs.

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a. S. 2313, 105th Congress, 2d Session, and National Commission on Retirement Policy, "The 21st Century Retirement Security Plan," Center for Strategic and International Studies, May 19, 1998.

FEATURES OF THE BALL (RESTORE LONG-TERM BALANCE) PLAN[a]

BENEFIT CUTS

- The number of years of earnings used to compute benefits would be increased from thirty-five to thirty-eight.

REVENUE INCREASES

- Benefits would be taxed in the same fashion as contributory private pensions.
- The maximum earnings subject to the payroll tax would be increased gradually by about 18 percent.

OTHER CHANGES

- All newly hired state and local workers would be brought into the system.
- By 2015, 40 percent of the trust funds' reserves would be invested in a diversified portfolio of common stocks.

a. Robert M. Ball with Thomas N. Bethell, *Straight Talk About Social Security: An Analysis of the Issues in the Current Debate*, Century Foundation/Twentieth Century Fund Report (New York: Century Foundation Press, 1998).

Mr. SMITH. Thank you. And without objection, I am going to ask Mr. Bentsen to ask the first question. He has to leave to make a speech. So Ken, go ahead.

Mr. BENTSEN. Thank you, Mr. Chairman, and thank you all for your testimony.

Some of my colleagues might say that this committee room is the land of free lunch, but I am not going to get into more on that issue, but for both of you, in reading Mr. Entin's testimony is it—Mr. Entin, your testimony seems to state that without question, in order to make an equitable transition, even if you go to a fully privatized system, but to pay the benefits that are accrued to current retirees that there has to be some public, some form of general revenue investment that you rank or you give the pros and cons, but am I reading that correctly, whether it is asset sales, debt, cutting Federal spending to redivert Federal revenues into the system, is that right?

Mr. ENTIN. Yes, and I regard all Federal revenues as revenues and all Federal outlays as outlays. I do not attach specific categories or labels to them. You need some money somehow to pay the current benefits to the current retirees.

Mr. BENTSEN. And then the other question is for both of you is you state, and particularly, Mr Entin, in your testimony at the beginning you talk about that none of the studies, or all of the studies so far have used static economic assumptions as it relates to the macroeconomic impacts of going to a privatized system and in fact, there are both issues of increased national savings that would occur and economic growth as a result of that as well as labor productivity for sociological reasons related to control of your investments and things like that.

With respect to the former, is that only true and I ask this because I do not know, is that only true at a time when you are running a general surplus because at some point I think we probably may go into a deficit and in a deficit period then we are just swapping—we are swapping who is investing in government bonds at some point. I mean we sell Treasuries to the Social Security Trust Fund by law. We also sell to plug a hole and in times of deficits you have to plug a hole. Somebody has to buy them, so if we use either what were Social Security revenues to buy private securities or it is done through private investments, is not that just swapping out for—I mean do not we lose some of that effect if we are running a deficit in the future?

Mr. ENTIN. In a sense, all of this is musical chairs as you have pointed out. When I had new math growing up, the teacher pointed out that zero was just one number on the number line and minus numbers and plus numbers were certain distances above and below each other and it did not matter whether you had a plus sign or a minus sign in front of them, it was the difference between them that mattered. If you were running a surplus and you do not spend the money and you do not cut taxes, you are going to buy debt back. That is negative borrowing.

If you are running a deficit, it is going to be adding to the debt. That is positive borrowing. In a sense, if you are running a surplus and then you decide to spend the money instead of paying down the debt, you are doing more borrowing than you would have done, so less debt repayment is equivalent to more borrowing and it does not matter if you start from a surplus or a deficit situation. You are doing less debt repayment than you would otherwise do.

Do not worry too much about that one little break even point of zero. That is not where the effect comes. If I am thinking of buying back some debt or in a sense not borrowing any more than I would otherwise do, that is one impact. The alternative to that may be that I could have cut taxes. You need to ask yourself a question, whether you are in a small deficit or a small surplus situation: Is paying down a little debt (or not borrowing a little) more productive in promoting private saving and investment, or is a tax cut on investment activity itself going to trigger more of a response and increase investment more?

If you do the arithmetic in any way, shape or form, accelerated depreciation, or lower corporate rates, are more likely to trigger a large increase in the capital stock than just paying down a little debt which may or may not get borrowed by a business for investment inside the United States.

Mr. BENTSEN. Mr. Reischauer.

Mr. REISCHAUER. I agree with almost everything Steve said. If we were to use the budget surpluses to reform Social Security and we were comparing a world in which we funded individual accounts with the budget surplus versus a world in which we paid down debt, there would be no difference in the overall macroeconomic consequences.

Would either of those two options be better or worse from an economic growth standpoint than a tax cut? There certainly are tax cuts that would probably have a larger impact, but the tax cuts that the Congress is most likely to enact are not the ones that

Steve has been talking about. They are things like the marriage penalty reduction which, if anything, would have a negative impact on economic growth.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Mr. SMITH. Let me start with each of your evaluations of the importance of having Social Security plans scored to show they are going to keep Social Security solvent. I mean my preference is that we do not stop just at 75 years because I think it is somewhat misleading and some of our witnesses have said in the past that the 76th year in some cases would mean that we go billions of dollars into debt.

How important is it to start with that the proposals that we have seen be scored for at least 75 years or more?

Mr. REISCHAUER. The issue here, I think, is that you want a system that is sustainable given our current set of assumptions for the long term. You do not want a system, a solution that is balanced over a 75-year period if that means huge surpluses in the first 35 years and huge deficits in the next 40 years. What you would like is a system that in the 75th year was in balance and looking forward, remained in balance. The plan that Henry Aaron and I proposed in our book is such a plan and I think some of the others are, but many of them are not.

Mr. SMITH. Well, such as the President's. The President is suggesting that somehow we——

Mr. REISCHAUER. But he is not proposing a plan that eliminates the deficit over the 75-year window.

Mr. SMITH. Correct. I mean he says let us reinforce the commitment that the United States is going to pay these benefits in the future by adding additional bonds to the Social Security Trust Fund.

Steve, Mr. Entin, your comment.

Mr. ENTIN. Anything you decide to do ought to be reasonably funded. It is better to have a funded than an unfunded system, year by year by year, because deficit finance does eat into saving and growth.

Mr. SMITH. Excuse me, I cut you off. Go ahead.

Mr. ENTIN. Well, whether you decide to focus Social Security more on a basic safety net program and let people do their retirement more in their private accounts, or whether you combine them as we do in the current system and have a big Federal program, whichever way you go, you should set it up such that it is affordable at a reasonable tax rate year by year by year by year, yes.

Mr. SMITH. OK, a question on the trust fund itself. If in the year 2010 the current estimate that you are going to need some money from someplace else, and there is only three ways to come up with that money to continue the benefits stream that has been promised. The three ways as I see them is you do more public borrowing, you cut other government expenditures or you increase taxes. With or without a trust fund, those are your three alternatives. How real is the trust fund, Mr. Entin?

Mr. ENTIN. As soon as the system needs more money than it is taking in in payroll taxes, the Secretary of the Treasury has to come up with money from somewhere other than the trust fund because there is no money in the trust fund and cannot be.

When he takes one of those trust fund securities and redeems it, he is issuing another security into the market or he is raising other taxes or the Congress is cutting other spending to give him the money to do it. This is the same outcome as if the trust fund were not there. It is not a funding source. It is only an accounting device.

In the Budget Committee you work often with actual outlays and you also work with budget authority. You have set Social Security up such that it is allowed to order the Secretary of the Treasury to pay benefits up to the point where it has got current revenues coming in under the payroll tax (its dedicated revenue source) and any previous excess that had been given over to the Treasury in the past. Social Security is allowed to spend that much. It does not mean the Treasury has the money. Treasury has to go out and get the money. But that sum of current tax revenue and past surpluses in the trust fund is the authority that you have given Social Security to go on its merry way without coming back to Congress for another authorization and appropriation. The trust fund is only budget authority. There is no real money in budget authority. It is the leash you have the system on. Do not ever think of it as a source of funding.

Mr. SMITH. The effects of reform plans on economic expansion is important so that the future pie is big enough to accommodate those two families, plus the effort to support one retiree. What is the effect since probably other government spending is not going to be substantially reduced which leaves the two alternatives of increased public borrowing or increasing taxes. Please give us your impression of the effect on the general strength and growth of the economy of those two options.

Mr. ENTIN. If you raise taxes in a lump sum way that does not affect behavior very much, fine. If you are going to borrow as opposed to raising taxes on investment, well that is fine for the short run. You would be better off than raising taxes on investment. Of course, you cannot borrow indefinitely and if the system is going to hemorrhage and be in deficit for the next 75 years, and beyond that date, forever, you cannot do the borrowing route, not forever.

So ultimately you have to trim benefits or cut other government spending if you want to preserve growth.

Mr. SMITH. Mr. Reischauer, my understanding is part of your proposal is supporting the concept of adding additional, if you will IOUs to the trust fund?

Mr. REISCHAUER. No. We cut benefits. We raise revenues a little bit and we increase the rate of return on the trust fund's assets by diversified investment in a portfolio of bonds and stocks.

In one sense, the trust fund is an accounting device. In another sense, it is a political device and by that I mean it sends a signal about where the adjustments that you spoke of will take place within our society. If the trust fund had in it right now $9 trillion worth of bonds (we can argue about whether those are real IOUs or not real IOUs or whatever) and we came to the point where payroll tax receipts and interest payments on these reserves were insufficient to pay benefits, then it strikes me it would be inconceivable to say to beneficiaries we are going to reduce your benefits or even to payroll taxpayers, workers that we are going to raise the payroll tax to make the necessary adjustment. The adjustment would take place in the balance of our budget. It might take the form of increased borrowing or increased income taxes or reduced spending on discretionary items or Medicare cuts or something like that. But it is really a very important political device pointing out where the adjustments will take place. If we have a system, as we do now, which is partially funded or more or less pay-as-you-go, and you come up to this crunch time, it is open for debate whether we will ask beneficiaries to tighten their belts a little bit or workers to pay a little higher payroll taxes or make the adjustment in the balance of the budget.

Mr. SMITH. Mr. Holt, we will assume that I went first and Mr. Bentsen went next, and so we will go to Mr. Toomey next.

Mr. TOOMEY. Thank you, Mr. Chairman. A couple of questions. In part of your testimony, Mr. Entin, if I understand it correctly, you address the question of whether savings that arise from a personal account system would crowd out savings that are already occurring. And I guess my basic question is while there is quite likely to be a certain amount of substitution effect, even absent the kinds of tax changes that you refer to such as faster depreciation or expensing that would, I agree, encourage capital investment and therefore encourage the likelihood of a greater net increase in savings, but absent all of that would there not still be a net increase in savings if we did move to a system where workers had the option of putting a portion of their payroll tax in personal accounts?

Mr. ENTIN. Yes, there would, but I was trying to counter the more extreme view on the other side that all of the saving would be new saving, that it would all be invested by American businesses and American capital, and that corporate income tax receipts would go through the roof and they would help pay for the system in a short time.

I gave the opposite situation. What if it is all displaced? What if some of it flows abroad? What if the businesses invest the money in Canada and they do not pay a higher corporate tax here until they bring the money home some time in the very distant future? And I suggest that if you have the domestic investment incentives and you begin treating other saving as it should be treated, which is to give pension treatment to it as you would under a sales tax or the Armey tax or the Nunn-Domenici system, you give yourself an insurance policy. You are more likely to have it come back.

Having said that though, we do treat saving and investment rather badly under the current tax code, and if businesses are rather fully invested in the United States, given the current tax and regulatory climate, there could be a great deal of slippage across borders. Either we buy the new issue of stock that is coming out of some internet company and the foreigners do not, so the capital inflow does not happen; or saving does rise and some company does borrow it, but puts its plant in Mexico; or we buy a global mutual fund if returns here are not all that high. So you do have to watch out for this stuff. We live in a global economy much more so today than we did 20 or 30 or 65 years ago. That is why I would urge you to put the two policies together. You will get a lot more bang for the buck.

Mr. TOOMEY. I agree with that philosophically, but since it is very, very difficult to do even one, to contemplate doing both is rather ambitious indeed. A follow up, quick question, if American corporations choose to take this capital and invest it abroad and assuming that they are behaving in a rational fashion, is it not therefore still safe to assume that this capital generates the same kind of return, although it may happen outside of our borders and therefore there is that added economic activity and taxable income to the government?

Mr. ENTIN. That is very true. There are several things to distinguish here. The retiree still owns a share of stock and the retiree will get a dividend on it and the retiree will have a better life and there will be some tax on that dividend unless you give it Roth IRA treatment, which you probably should. So yes, there is that factor.

The added gain, however, from having the plant built in the United States as opposed to abroad is that, while the worker is working and before he begins to get his dividend, his own saving is being put to work to expand the capital stock in the United States. Consequently, his productivity and wage will be higher while he is working and he will have a higher level of income while he is working and so will his children while they are working. Also, the government will get some revenue feedback from the higher income taxes of the higher-paid workers, and from their higher payroll taxes. It does give you a little bit of the money back to help pay for the transition.

Mr. TOOMEY. Thank you. Last question that I have, some of the Social Security reform proposals are in some ways really not reform so much as proposals to address the funding deficit of the system. Is it your opinion that if we were to use the Social Security surplus and it will take additional surpluses in a reform system that does solve this funding deficit without fundamentally transforming the system into one of a prefunded personal account, that that would be better not to pursue that and instead wait for the opportunity to make the profound reforms or that we ought to do—solve the funding problem if that is all we can do?

Mr. ENTIN. Very soon you are going to have no choice but to solve the funding problem. You have got a deadline. If you just solve the funding problem, there will be a great tendency (and this is a psychological problem, not a factual or technical one) on the part of the Congress to say, ''We have done the job, let us not do any more.'' In that case, it will have passed up the opportunity to give people much higher incomes while they are working and much higher incomes while they are retired by moving from an unfunded to a funded system that would promote a good deal of economic growth and capital formation and productivity gains.

Mr. TOOMEY. Thank you. Thank you, Mr. Chairman.

Mr. SMITH. Mr. Holt.

Mr. HOLT. Thank you, Mr. Chairman. You have addressed my first question which was a little, I wanted a little more elaboration on the effect on savings and I think you have, you have said a lot about that.

But let me ask, I guess, a general question that has to do with political pressures and I would like to ask both of you on this. With an individual saving program, how can Congress resist the pressure that will come from the general populace to seek benefits that are closer to the highest yield benefits that the more successful investors are getting? In other words, we can easily talk about putting a floor in there, so that no one loses their shirt, but this could turn out to be a very expensive program if it is a spiral with everyone trying to receive returns that are comparable to the highest returns that the shrewd investors are receiving. I see that as a fundamental political problem that would have to be guarded against.

Do you have any comments on that?

Mr. REISCHAUER. You are implying that individuals would have wide latitude to decide what their contributions were invested in as opposed to many of the plans which suggest that there be a limited number of index funds, something like the Federal Employees Retirement System funds or even a situation like the Archer-Shaw plan which says there will be many fund managers, but all will be invested 60 percent in stock, and 40 percent in bonds and there will be indexed funds so that in a world like that, the benefits and returns would be the same across the various taxpayers.

I agree with I think where you are coming from which is that if there are wide differences in returns and wide differences in the pensions that result from a system like this, it will be politically unsustainable and those who feel they came out on the short end will exert political pressure to have their situation redressed.

Mr. ENTIN. I take a different view. The current system has benefits that range from about minus 2 percent to plus 3 percent. There is a wide spread between the benefits that low-income workers get and the benefits that high-income workers get. The percentage returns are higher at the bottom, but the difference in dollar benefits is quite sharp. You have got benefits of around $11,000 for the average wage worker; $8,000 at the bottom and currently as high as $14,000 or $15,000 for workers at the top end of the pay scale. A married couple in the future (75 years out) where they were both professionals and paying taxes right at the top was covered by the system would take home in today's money over $60,000 in benefits. And a single retiree, at the low end of the spectrum would take home around $20,000. You have got discrepancies in the current system as well.

If people have their own IRAs and pensions and savings bank accounts, they generally do not find out what their neighbor is getting. Under a reform program, if you did not have the government mandating restrictive packages where everybody had to put their money into the same investment option, and people were allowed more latitude, there would be variation in outcome, but it may be that people are happier that way.

I have a very good friend who certainly is as intelligent as I am and whose parents left him as much money as mine did. I put mine in a mixture of bonds and stocks, but he put his in bonds (and a couple of utilities) because he swore he would never lose a dime. My savings have grown more than his and I keep saying, "Why do you keep doing this?" And he says, "Because I am happy this way. I am never going to lose anything and your portfolio might drop 5 or 10 percent some day." I am happy because I am more comfortable with risk than he is. He is happy because he is less comfortable with risk than I am.

People should have the option to do what makes them happy, and if they are happy, they are not going to make these complaints. And if they are not part of the government guaranteed safety net, if they are living off their own retirement income, and if the safety net is still there for everybody who needs it (and Bob, I do want to keep a safety net), then I do not think they will have a complaint. I think if people know they are not investing in America Online, they are investing in Potomac Electric, and that they are therefore going to get a different rate of return, and if they make that choice up front, they will live with the consequences, willingly.

Mr. HOLT. Thank you. That is all for the moment.

Mr. SMITH. Mr. Ryan.

Mr. RYAN. Hi, Steve. It is good to see you again. Mr. Herger and I and members of the Budget Committee have worked on what we call the lock box and I know you may go down that questioning as well, but let us assume the lock box is in place. I would like you to comment on lock box legislation.

What will be achieved if the lock box is achieved is the off-budget surplus, the Social Security surplus for lack of a better term, will be used to pay down publicly held debt if we do not have a Social Security plan to which to dedicate those dollars.

Can you comment on the economic policy and the economic effects of buying down publicly held debt with off-budget surpluses as opposed to spending that money up here for something else, and not as opposed to tax cuts because I think you touched on that a little earlier. Do you believe that buying down publicly held debt will help us when 2013 comes because those bonds will be redeemed on top of a lower level of publicly held debt? Let us put aside benefit cuts or tax increases. We had a vote of 416 to 1 earlier this year against benefit cuts or tax increases. So the will of Congress has essentially spoken on this issue in a resolution against benefit cuts, tax increases which leaves you redeeming these bonds, and increasing debt absent a comprehensive Social Security reform plan. Can you comment on that, each of you?

Mr. REISCHAUER. I strongly favor paying down debt and reserving, protecting the Social Security surplus for this purpose I think if you do that you are going to strengthen the economy as well as reduce interest payments, as well as prepare yourself for the situation the second decade of the next century in which you are going to have to find some way of making ends meet within the Social Security system. So I am strongly in favor of a policy such as you described.

Mr. ENTIN. If we could sit down for 15 minutes in your office with a pad of paper and I could draw pictures, I would be happier right now, but maybe we can do that later.

Let us think ultimately in terms of the real economy and not just these financial transactions. We will only start with the financial transactions. If your only choice is to spend the money on current government consumption or pay down the debt, meaning there would be less current government consumption, you have an economic benefit because the resources the government would have consumed, manpower, steel, concrete, computer chips, whatever, would not be taken by government and would be left for the private sector to potentially build an apartment building, a factory, an air-plane or machine. By refraining from consumption, you are transferring real resources to the private sector for private sector expansion, which is better than having the government spend the money. Yes.

The mere fact that you are paying down debt will not necessary change interest rates very much in a huge global economy, however. It will not trigger a huge burst of private sector investment just because of the change in government finances. It may help private sector growth because of the resource transfer, but not because of the finances.

When it comes time to issue another bond in 30 years to redeem the trust fund to help pay for the baby boomers, you will be borrowing money at that time. And it won't matter much whether you have been borrowing a lot or not borrowing a lot, whether the government is big or small as a share of the economy; the incremental damage by issuing that piece of paper 30 years from now, and taking a certain amount of resources 30 years from now, will probably be the same whether you start from a high base or a low base, assuming that the resource transfer will be the same magnitude in either case.

Now if you have managed through debt reduction to keep taxes lower 30 years from now than otherwise because you are not paying a lot of interest, so that tax rates can be lower rather than higher, that is good. But raising the tax rate by that same amount to redeem that trust fund bond in the future will still do some damage. It will do a little less damage if the rate were low to start with.

Mr. RYAN. So you are saying crowding out does not occur?

Mr. ENTIN. Do not think of it in terms of financial crowding out. Think of it in terms of resource crowding out and ask yourself do you want to raise taxes in either case?

Bringing down debt today simply to reissue it later is not going to undo the damage later.

Mr. RYAN. One quick question for each of you. There is legislation in both the House and the Senate—Domenici has it in the Senate and some of us have it in the House. It would take apart the debt ceiling—you have the private debt and then you have the public debt—and rachet down the public debt ceiling. It is sort of a staircase where we ratchet down the public debt ceiling by the amount of the Social Security off-budget surplus.

What is your thought on that legislation specifically? Do you think that cash management issues arise with the Treasury Department? Or do you think that that is an appropriate way given the fact that it is tough to keep that money from being spent up here? Is that a good way to capture those savings and apply it to public debt?

Mr. ENTIN. My former colleagues at the Treasury would scream if they had any ceiling put on them. They always do.

If it keeps you from doing the spending in the first place, you are never going to hit the ceiling anyway. So if it will stop you from spending, fine. But basically, you have to decide to stop spending. You have got to behave yourselves, one way or another. However you go about making yourselves do it, that is fine.

Mr. RYAN. Well, you do not see any ill economic effects from changing the debt ceiling in that kind of way.

Mr. ENTIN. No.

Mr. REISCHAUER. The proposal that Senator Domenici put forward, I think, is seriously flawed in the same way that the Gramm-Rudman-Hollings procedure was seriously flawed in that it ratchets down the debt ceiling without regard to the state of the economy and other factors that can affect spending and revenue in the country.

I am not completely familiar with your proposal, but the version that I had seen earlier did not suffer from that——

Mr. RYAN. There is a new version that takes into account a recession, and the bill would change the date of debt buydowns to May 1 to help take care of the bad cash flow months. So the new version of the bill tries to take those criticisms into account.

Mr. REISCHAUER. There are lots of uncontrolled forces that, uncontrollable forces that affect the spending and revenue of this country as anyone who has lived through the last three Aprils should know on the revenue side or anybody who has taken a glance at the Medicare figures over the last 2 or 3 years. There is not an analyst alive that 3 years ago would have told you that Medicare spending for the first 6 months of 1999 would be 2.5 percent below the level for the first 6 months of 1998. These things are inexplicable and you do not want to write into law procedures and rules that do not reflect the uncontrollable nature of our government activities.

Mr. RYAN. Well, let me ask you——

Mr. SMITH. The gentleman's time has expired. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman. I do want to follow up on this question and it may be a little bit different aspect of it. I think Mr. Entin you made a comment that concerns so many of us and that is that we, the Congress, have to behave ourselves. I think that is what concerns the American public, the American voter. I mean everybody. And of course, the age long temptation is that it is—it would appear to be much easier, I am oversimplifying—easier to be re-elected if we are spending than if we are saying no, tightening our belts. At least that is undoubtedly oversimplification that I see it in.

Coming back to some of the legislation that we have, specifically, some legislation that I have concerning the lock box and the goal behind the lock box to somehow make it more difficult for the Congress, not impossible, but more difficult for the Congress to spend this money, money that is, or dollars or somehow allocated, dollars that will be needed for retirement, particularly after the year 2013, my question goes into the unified budgeting, something we have been doing since 1969, something that was done, evidently, to help make the war in Vietnam appear not a deficit, not to be as large as it really was and one aspect of the legislation that I have would at least have us where we are not counting it anymore. It is still there, but at least not on one line after the other and the purpose of this is to make it more difficult for those of us here in the Congress to spend money which really is not ours to spend or at least that is the way many of us look at it.

I was just wondering if you would comment, your support or opposition of this, whether this is something that is something that we should be pursuing to try to return this to as it was prior to 1969 or not.

Mr. Entin, first.

Mr. ENTIN. As I mentioned earlier, I really think of all government revenues as revenues and all government outlays as outlays because that is the economic effect.

When Mr. Ryan asked the question, he said, if we are going to spend it or pay down debt, as between the two, what would I say? If you really wanted to return this money to the people and not have it for government to spend, and if it were from the payroll tax, one thing you could do is to temporarily cut the payroll tax. That would give some additional work incentives and help the economy grow a little bit in the interim. I think that would be as good as paying down the debt.

Or, you could give a temporary tax cut to capital. I would rather see you give a permanent one, but if you are going to open things up, that would be the way to go.

You have pointed out that there is a problem with labeling and with the way people perceive things. You are right, they do perceive things that way. They look at that number, and if we gave them a different number to look at, they would see something different. The best thing, however, is to give them a thorough education in what all the numbers mean and to point out that in a sense, it is rather a semantic game, and that they should not think of things that way. That is a lot more work than trying to address this symptom (and that proposal would address the symptom) but ultimately, I think it might pay off.

If you carefully explain to people and to the members that we really have to do something about saving and investment, and not play the game of envy of rich versus poor, it would be good for everybody. The workers would be more productive and have higher wages. And it is really the only way to address this problem without cutting into people's living standards at some point or another. This is more important for them than the current transit subsidy or the Big Dig in Boston or the highway demonstration projects in West Virginia or the shale oil subsidy in wherever it is.

If you were to ask the voters, "Would you be willing to give up some of this Federal spending in order to double or triple your retirement income, and be able to do it by setting aside only 5 percent of your income instead of the current 10 plus percent payroll tax?" People might very well say, "Gee, I am going to look into that. Oh yes, I see. You can cut the Federal spending. I am going to stop demanding it because I would be much better off if you did the other thing."

Mr. HERGER. Well, I would like to pursue that if I could, just with that line of thinking. This is a concern I have is that in the eyes of the American taxpayer, they see this money and I want to now expand this, not just to the trust fund of Social Security, but the trust fund of the airport trust fund, the trust fund of the road trust fund which we have not been talking about and probably 112 other trust funds. Is that the American taxpayer thinks in terms of this is money that they are setting aside to be spent just in this area, but yet we know that is not what has happened. This money has been co-mixed and even though what you are saying is true and it would be nice if we could take the time to be able to try to explain this to each and every American and each and every Member of Congress who probably semi already understands it, but the fact is that is not what is happening and I would almost debate from a political standpoint what you are saying would be nice, but next to impossible to do and be successful at.

I am concerned that we need to begin separating what the people have dedicated this money for and either changing what we are doing and calling it something else which would be fine if by policy we decide to do that, but otherwise begin spending this money whether it be in Social Security to allow the taxpayer to invest it in a fund, in a form which you would probably term a tax reduction, but yet it is utilizing those same dollars. Whatever it is, I think we need to be honest and I believe what we are doing now is nothing short of being dishonest, in essence.

Anyway, I wish we had more time to pursue that, but thank you.

Mr. SMITH. We will start a second round at this time. Let me ask the question regarding some of the other proposals. One of the other proposals suggests adjusting the CPI. Is that a good way to enact reform? Starting with you, Dr. Reischauer and then you, Mr. Entin.

Mr. REISCHAUER. I think it is an inappropriate way to reduce benefits if you decide that reducing benefits is important to—the solution to Social Security's problem.

If you reduce the CPI through some rule like indexing the benefits to CPI minus half a percentage point, then what you are basically doing is saying that the burden of these cuts will fall most heavily on the old, old and we know quite well that as people age, their incomes fall because their pension benefits fall and their retirement savings are depleted as they get older. I think it is not an equitable or a sensible thing to do.

Mr. SMITH. Mr. Entin.

Mr. ENTIN. Well, you have touched on a real pet peeve of mine, if I may say so, sir. I am not a big government fan, but over the years I have spent at the Treasury and as an economist I have developed a lot of respect for the technicians in the various departments when it comes to number gathering. I think to second guess the Bureau of Labor Statistics on the CPI would be a major mistake.

To actually force them to reduce their CPI number beyond what they think is appropriate, or to take the number and then fudge it by half a percent, would hit the retirees and it would hit the workers. Of course, it would hit the retirees twice and the workers once in the following sense. You would be trimming Social Security benefit growth over a worker's retirement, but as each worker dies that effect goes away. Each new worker comes in under the unchanged initial benefit formula with a new initial payment, and he starts from scratch, and then you start whittling his subsequent COLAs down again. You have got a sort of limited saw tooth saving on the retirees. But on the workers and on the retirees' other income, subject to the income tax, you would be watering down income tax indexing. The tax brackets, in real terms, would narrow a little more every year. The effect would go on and on and on and get worse and worse. More and more people, retirees and workers, would be pushed up through the tax brackets. They would have less incentive to work, and less incentive to save. Labor costs would go up. It would be slow, not as fast as with bracket creep before the 1981 tax cut where we instituted indexing. Not as bad as in the late 1970's when we had double digit inflation. But you would still have bracket creep. It is bad for the economy and it is a hidden tax hike and it never stops. So it is a very bad thing to do.

Mr. SMITH. Let me query your impression of the effect on the economy by going outside the traditional FICA tax or payroll tax to solve the problem of Social Security.

Mr. REISCHAUER. I think you can make a case for why general revenue transfer to the Social Security trust fund is appropriate and that case would be based on the fact that during the first several decades of the Social Security system that system was asked to perform a welfare function. We boosted benefits very significantly over what the original law called for in an effort to raise incomes of the elderly and by doing so we reduced old age assistance payments.

However, that aside, I am not a big fan of using general revenues to strengthen the system. I think the system through some judicious and rather small benefit reductions and some expansion of the tax base by bringing in new employees of state and local governments and an investment policy that collectively invested a portion of the trust fund reserves in a diversified portfolio is sufficient to bring the system into long-run balance.

Mr. SMITH. Mr. Entin.

Mr. ENTIN. I would have no objection to general revenue infusions if they were being used in a transition to a system where the Federal role in the retirement side of Social Security were substantially reduced, if it were temporary and leading to a great shrinkage of that role.

The welfare aspects of Social Security ought not to be handled by a payroll tax. They ought to be handled by the income tax because welfare is a transfer from those who can pay to those who cannot, and the income tax more generally follows that ability to pay than the payroll tax.

Again, you have a system that is combining a welfare system—a safety net floor—with a retirement system. They did not need to be merged. I am trying to urge you to get people to do more and more of their retirement saving in personal accounts, and shrink the retirement portion of the government system. Keep a safety net, perhaps by helping people put money into their retirement accounts out of general revenue, if they cannot contribute enough while they are working. Alternatively, when they get ready to retire, if their accounts are not quite big enough, add something to it. But do not merge the welfare and retirement systems the way they are now.

Use general revenues to transit out of the current system. Do not use general revenues to support an unfunded system that simply drags on without promoting real saving, does not move us to real saving, does not move us to real investment and does nothing to expand the economy.

Mr. SMITH. Mr. Ryan.

Mr. RYAN. Dr. Reischauer, I would like to go back to where we were with the debt ceiling language that we have been talking about. You mentioned in your first answer that you thought buying down public debt was a good idea but you seemed to have concerns about the way we do that.

Could you address those concerns? Ratcheting down publicly held debt to capture off-budget surpluses to dedicate them toward paying down publicly held debt is basically encapsulated in this legislation about which we are talking.

It seems to be an artificial way of making sure it gets done, but what are your concerns with how that is done, provided these cash management problems are addressed in the legislation? Do you think they can be addressed? I would love to see your reaction to the legislation after its latest changes and if you do not think that is the right way of going about it, how else would you propose to do it?

Mr. REISCHAUER. Well, I will be glad to look at the revised version of your bill, but I would be more comfortable if the Congress, in its budget process, began to focus on the non-Social Security portion of the budget and said that we are not going to run deficits in that portion of the budget, not ever.

Obviously, there are going to be wars. There are going to be recessions, when this is unavoidable. But we are not going to consider tax cuts or spending increases to the extent that they might tip that balance into the negative. I am not sure debt ceiling legislation does much except create periodic crises in the Congress than can be used or misused, for other legislation. I have watched debt ceiling bills through the last 20 years and they are not pretty things to watch.

Mr. RYAN. Well, your comments on the on-and-off-budget surpluses I thought were interesting. With the budget resolution, we make a pretty strong difference between on-and-off-budget surpluses and with the on-budget surpluses as you well know, we dedicate that toward tax reduction. I would like each of you to comment on the economic benefits toward dedicating on-budget surpluses toward tax reduction.

Specifically, we want to make sure that these surpluses do materialize so we can take care of these issues. If we do not have these surpluses, we are really stuck. So if you could comment on that.

Mr. REISCHAUER. Well, I am concerned about what you did in the budget resolution for two reasons. One is these surpluses are highly uncertain and we all know that. And the surpluses are based on a set of totally unrealistic assumptions.

Mr. RYAN. Too conservative or too liberal?

Mr. REISCHAUER. Too conservative. And I am making this rather rude statement based on your behavior, not on what you have been saying. I see no way in which you are going to stay within the discretionary spending caps this year. I see no way you are going to stay within those caps over the next 3 years. To make a commitment on the tax side which would tend to be irrevocable, I think, is quite frankly irresponsible, given that situation when the Chairman of your Appropriations Committee is saying there is no way we can live within these caps.

The Chairman of the Senate Appropriations Committee is saying there is no way we can live within the caps. And everybody is sitting around waiting for somebody to cry uncle on the caps.

Mr. RYAN. But you would agree that higher economic growth will assure that these surpluses materialize?

Mr. REISCHAUER. If we have higher economic growth, the surpluses will materialize, but I am not sure why we should assume there will be higher economic growth.

Mr. RYAN. From tax cuts. Obviously, you mentioned not all tax cuts are created equally, but some tax cuts, you would agree, do promote economic growth and I would like Mr. Entin to comment on this.

Mr. REISCHAUER. But what we are talking about here is the difference in the impact on economic growth between paying down the debt which is imbedded in the baseline assumptions and the tax cut and I would be very surprised if on balance the tax cut that made its way through the Congress had a greater impact on economic growth than paying down the debt. It will not be a tax cut that is designed by——

Mr. RYAN. Fair enough. If you could comment on this, Steve.

Mr. ENTIN. I am glad to see that Bob thinks that if I were put in charge of designing the tax cut I could do some good. I agree with him.

Mr. RYAN. Do not be so modest.

Mr. ENTIN. I take more liberties as I get older. Now that I am older than some of the Members. It did not used to be that way.

Mr. RYAN. I get that every day.

Mr. ENTIN. The way to cut through all of this, really, is to have the Congress go away somewhere out of the limelight, get a real education in what the numbers mean and how the economy works, agree to put politics aside and do what is technically the best that we can figure out, as economists with reasonably modern training, that you ought to do. Then go back and, as a united group, tell the public, "We did this for your good, and here is why it is for your good, and we think you will agree with us if you look at it carefully."

In reality, what you are faced with, however, is the very open political hurly burly that goes on, where the technical stuff is not really considered, and it is people maneuvering for advantage. That is very distressing for technicians such as us to deal with, but I guess we have to.

I am not terribly afraid of a Gramm-Rudman type ceiling because I remember from the Reagan years that when the economy slowed down, the ceiling was adjusted. You have a projected surplus. I suppose every year when the CBO reestimates the surplus, it will automatically, perhaps, readjust the amount that you are locking up. If there were an emergency, I am sure Congress would pass an adjustment.

Mr. RYAN. And that is in the bill——

Mr. ENTIN. The restrictions just make it a little harder to do, so that does not bother me particularly. What bothers me is your need to do it. I sympathize with your need to do it. I understand where you are coming from. I just wish you did not have to.

Mr. SMITH. If the gentleman will yield with your time up anyway. Let me just follow up a little bit on the question of separating the debt limit for the on-budget and off-budget debts. I have heard some of your comments relate to the suggestion that the trust fund debts are not that real. Is there any legitimacy to that?

I am concerned that separating the on-budget and off-budget debt limits in some way reduces the realness of the debt owed to the trust funds and I am just nervous that there is a danger that politicians are going to act on the Social Security trust fund as they did on the transportation trust fund; that is simply wipe it out and say well, we do not owe it any more.

We have come to a compromise settlement and I see some danger there, that it is going to promote additional borrowing from the off-budget trust funds without the intent of repayment. Can I get your reactions?

Mr. REISCHAUER. I really have not thought that through. That is the first time I have heard that concern being raised, that if debt owed to the trust fund is not part of debt subject to limit, it will carry, in a sense, less weight in the political system. I do not think so. I think that the figures in the trust fund balances and the size of the population, 65 and over, or 62 and over, insure that that debt has very real political meaning.

Mr. SMITH. I mean if we have debt limit for public debt, is there a danger that we simply increase some of the taxes coming in to the highway, to the airport trust fund or any of the 136 other trust funds, including Social Security because we do not have that kind of pressure?

Mr. Entin, your reaction?

Mr. ENTIN. I hope I am not misunderstanding the question.

Mr. RYAN. Will the gentleman yield?

Mr. SMITH. Yes, Paul.

Mr. RYAN. Is your concern that if we splice the debt ceiling in half, we have a private debt ceiling and a public debt ceiling and we are racheting down the public debt ceiling, but leaving the private debt ceiling. I think we understand private and public debt as it is commonly known.

Private debt owned within government—Social Security trust fund and trust fund debt—and public debt are, for example, public bond holders debt. That is how the politicians call the difference in these debts.

Are you concerned that if we separate the ceilings and we ratchet down the public debt ceiling, that we will have a new financial debt tool that will disregard or pile debt over on the private side? Is that your concern?

Mr. SMITH. Well, no, that if we have got an absolute mandate to lower the debt to the public, so the ramifications of increasing the airline ticket tax to bring in more surplus from that trust fund to spend on other government programs, in other words more trust fund debt but no increase in public debt.

Mr. RYAN. Right.

Mr. SMITH. So to a certain extent you are suggesting that the debt owed to the trust funds is less important than the debt——

Mr. RYAN. And you think that might change the behavior of future Congresses——

Mr. SMITH. Well, it could.

Mr. RYAN. And Executive Branches?

Mr. SMITH. Yes.

Mr. RYAN. And grow private debt to take care of the problems we have with public debt going down?

Mr. SMITH. To grow the debt to other trust funds could be a danger.

Mr. RYAN. Yes.

Mr. SMITH. Mr. Entin.

Mr. ENTIN. I suppose if money were tight, then yes, you would raise the money flowing into a trust fund, say the gasoline tax, for example, and then spend it on something else. It would not be that you are defaulting on the trust fund debt in the gasoline trust fund. You just would not be using the money as it flowed in for the specified purpose. That debt would still be there and you might choose to leave it on the books forever. It would be a mockery, but you could leave it on the books forever.

It is for that reason that I would prefer not to see any trust funds. I think the highway lobby should go to the Appropriations Committee and the Transportation Committee every year and duke it out with the airport lobby and the other lobbies and the other committees for general revenues. I do not think there should be dedicated trust funds. Then you cannot get away with this and they cannot get away with it.

Mr. SMITH. Did you suggest that earlier to Mr. Shuster?

Mr. ENTIN. He did not ask, sir. If he had, I would have said that.

Mr. SMITH. Mr. Herger.

Mr. HERGER. Well, just a comment on that. My concern is and just my feeling is and I really feel this is the—I think I am reflecting at least the opinions of those I represent in rural Northern California and with complete respect to you, Mr. Entin, that is not the way, at least the taxpayers I represent want to see it. I am very much aware that that is the way it is taking place. I mean what you are describing is basically what is happening today. And what has been happening since the creation of these trust funds.

But the taxpayer does not see it that way, at least the overwhelming majority that I represent and I would go so far as to say that those nationally, that when they go and buy a gallon of gas and there is so much of that tax that they are told is going to a gasoline tax and they are riding these rural roads that have potholes in it, by golly, they want every penny of that to be going to repair those potholes.

And the individuals that are paying taxes on an airline ticket want to see those airports improved. And this concept which is actually taking place that you mentioned that they should duke it out is exactly what I would contend the American public does not want to have happening, but yet is what is happening and we need to somehow get off this fix that we have been on, dedicate these, whatever we call it, maybe we need to come up with a new name. Obviously, trust fund has not worked.

So maybe we need to call it something else and begin having it work as it was originally intended and as most Americans think it is doing now.

Your comment?

Mr. ENTIN. You are taking a tax which you are viewing and your constituents may be viewing as a user fee and then you are not using it for the use for which they are paying the fee.

Mr. HERGER. Precisely.

Mr. ENTIN. If these, in fact, were user fees closely tied to the outlays and the purpose specified, and it could be made to work that way, I would see the complaint more clearly.

But you have a more fundamental problem. The gasoline taxes that your people are paying in your district may go to put more roads together halfway across the country. The spending is not local. They do not have control over the user fees they are paying. It is not going to the highways they want fixed. Or it may go back to your district if you are very skillful here in Congress in making certain that it is for your district. But some other Members may not be as skillful for their districts.

The basic rule is, if the Federal Government could actually charge a meaningful user fee for a particular service, it could be privatized because the private sector could charge the user fee and provide the service too. The government is supposed to get involved when there are externalities or public goods, and you cannot use the market because of market failure. So if you could be doing it the way you hope it would work, you would not really have the responsibility for doing it at the government level in the first place.

Some other nations—Canada is in the act and I think Britain has already completed it—some other nations are privatizing their airports. No private airport would put up with the obsolete and unreliable computer systems that the FAA is sticking us with. People would get better service at the airport, better service from the air traffic control system, if private enterprise were doing it and charging the airlines that were landing at that airport for better service.

We have an airport trust fund which half the time is not being used for the purpose it was intended, and when it is being used for the purpose it was intended, some Washington bureaucracy picks which airport is going to get which service this year, and some airports are getting absolutely nothing for years and years and years, and they have plane crashes.

If those airports wanted to get going faster, and they were willing to pay more for it, and they were private, they could do it. But if it is public, they cannot.

I would say you have a bigger problem with these trust funds than the mere fact that we are abusing the heck out of them. They really should not be there in the first place because the government should not be doing these activities in the first place.

And if government is going to intervene, it should be transferring the money to the local authorities, and the local authorities should be able to add their gasoline tax, their California gasoline tax, and their county gasoline tax if there is such a thing, to repair the county roads.

Mr. REISCHAUER. Let me jump in here and say your constituents should be quite happy to pay that gasoline tax, even if it leads to improved roads in Michigan.

Mr. HERGER. And I agree with that. We drive all over——

Mr. REISCHAUER. You drive all over.

Mr. HERGER. Exactly.

Mr. REISCHAUER. People drive from Michigan to visit Northern California. Goods that you purchase come from Michigan. It is one large system.

The best studies of the highway trust fund show that, looked at over the last decade or so, there is no squirreling away of resources, that the obligations that have been made, will for all practical purposes absorb the resources that have been paid into that system.

And for many of the other trust funds that you are taking to task here it is worth remembering that a large portion of the costs of our air traffic control system and our airways system are being borne by general revenues. And this is not a situation in which the air traveler, in a sense, is being immensely short changed.

I am interested in Steve's complaints about the U.S. airports. And I am not great fan of them, but having traveled abroad, I am not great fans of a lot of the airports abroad either. Anybody who sat in Paris for four or 5 days waiting for their air traffic controllers to get off of a strike or something like that——

Mr. SMITH. I think we will sort of bring this out of the air and back down to the earth of Social Security and Mr. Ryan has a question on USA accounts.

Mr. RYAN. Earlier in your testimony, Steve, you talked about possible crowding out that might occur from a private Social Security system or a pseudo-private Social Security system crowding out other investment and I think you might have touched on that a little bit, Dr. Reischauer.

Looking at the President's USA account proposal, the early inception of the proposal seemed to have glaring problems whereas it would have crowded out private savings portfolios. They say that they have addressed those concerns with new provisions in their proposal. I am not so sure that is the case.

Could you comment on the President's USA account proposal with respect to whether it will displace current private savings portfolios and pensions, 401(k)s? Will this send a signal to businesses that well, we have this USA account proposal so I do not have to offer this to my employees.

Do you think it is going to go down that type of a road? Could you comment on that?

Mr. ENTIN. It is like trying to shoot down a cloud. It has got a lot of problems and you really do not know where to aim.

First of all, it is taking money that could be used to cut taxes on IRAs and 401(k)s to make them go up. I would not even object to having the government give some money to individuals who are too poor to put much aside in the 401(k) plan to help them put some money into one. The plan, however, has a peculiar tax treatment. There are alternative uses of the money that could do just as much good without the peculiar structure.

The next problem is, you get the money if you earn as much as $5,000 a year, and you continue to receive it as you earn more income, but then when you go above a ceiling amount of income, you start losing the government subsidy. That has the effect of boosting your marginal tax rate by a percent and a half, so in effect, it is an implicit increase in tax rates which discourages other saving. Maybe not horrendously, but it is still a bad thing to keep adding new phase-outs to the tax law. At IRET we did a paper a couple of years ago, written by Mike Schuyler, pointing out 26 phase-outs. We have added to them since. They all have implicit, hidden marginal tax rate effects. The Joint Tax Committee did a paper about the same time. We keep adding to these things.

The USA plan is a most peculiar way to deal with saving. Why does not the government simply treat saving fairly, as in a consumption based income tax, and then let people do what they want to do. If people are poor, we can give them some help doing it. But there is no need to have all of these peculiar rules and regulations and tax hikes involved.

Mr. RYAN. In a nutshell, do you think that USA account proposal will have an adverse impact on private savings?

Mr. ENTIN. I do not see how it is going to improve total national saving. Exactly what it does to the private saving versus the government budget surplus and where the fall out comes, I will not guess, given the complexity of the program, but I not think it is going to help total national saving.

Mr. REISCHAUER. I would come down that it would have a slight impact in a positive direction on national saving. Obviously, the distribution of the resources versus paying down debt with them is a wash, except to the extent that the distribution to the savings accounts might lead to some slight reduction in other private saving, but at the same time, the matching component of this should encourage slightly some saving by individuals. The fact that the Administration has allowed 401(k) contributions to be used as the individual's match, I think, protects it from the first concern that you raised in your question.

Mr. SMITH. I am going to ask either of you if you have a closing statement. Maybe you might react to the concern that many of us have right now that there looks like the chances of passing Social Security reform that is going to keep the system solvent are not good at this time because of the perception of political consequences of coming out with a proposal that increases taxes or cuts benefits or changes the way that investments are made to some of the money coming in.

What are your suggestions? I mean I am going to move ahead with it. I am going to yell and scream and hopefully the Members of this Task Force will also. Congress tends to be shifting its consideration to partial fixes such as additional bonds into the trust fund, such as proposals of putting in a lock box that might help us some in future years when we start borrowing back the money.

Do either of you have any suggestions of how we might take action to keep the momentum going in terms of increasing our chances to pass legislation that will keep Social Security solvent?

Mr. REISCHAUER. I do not have any particular suggestions. I think this kind of issue does not move forward without strong and consistent presidential leadership and a willingness on the part of the President to take significant risk, political risk. And given the other issues that are on the agenda right now, and the lateness of the date, I do not see that happening.

Mr. ENTIN. If you can do it right, go ahead. If you cannot do it right, stall. There is an educational problem, although I think the public may be ahead of the politicians (not ahead of the pollsters, they are capturing the public's feelings). I think the public may be ahead of the Washington establishment.

People want private accounts. They trust them more than a system they know is underfunded and may not be there for them. They may not realize just how much additional economic growth and income they could get even while working if they had private saving accounts. If anything, that information would strengthen the public's resolve to move toward private accounts.

The public may be well ahead of the Congress. I think, sir, your proposal and the reaction you have gotten in your district is more realistic as to what is happening out there than some of what we hear around the city about how it still may be the "third rail" and so forth. You know better. Your people know better.

You have a plan that gradually moves those people away from reliance on Social Security and more toward reliance on the personal accounts that are going to be set up. There is a scaling down of Washington's involvement embedded in your plan.

The public is ready for that. If you can explain the benefits, I think the public will not only let you proceed, but will urge you to proceed, so go to the grass roots.

When John Kennedy campaigned, it was on the basis of getting the country moving forward again. He explained how his tax reduction plan would do it. He had an investment tax credit, and he had marginal rate cuts, and the recession in the late Eisenhower administration kept Richard Nixon out of the White House for a while. Reagan came in with the same notion. He wanted the tax cuts to get the economy moving forward.

If you present the right kind of Social Security reform as a way of getting the country moving forward, of increasing people's welfare over their lifetimes, of expanding their incomes, I think you will find that the public will be dragging the Congress along and saying, "Move now! We are willing to do it." Until you have got the public dragging the Congress, you may find people coming up with inferior plans such as we have now in some cases.

The President's plan is basically to open up the general revenue floodgates, not to help us transit to a smaller system that is more private, but to open up the general revenue floodgates so that we never have to fix the system. That is where he seems to be going, and I think there is a little bit of that even in the Archer-Shaw proposal.

So if that is the best you can do, stall. If you can get the public dragging you in the right direction, you will have solved your momentum problem and you will have solved your quality problem at the same time.

Mr. SMITH. Thank you both very much. For the record, the Steve Goss and the actuaries are doing their last stages of scoring our plan and hopefully that will be introduced in the next couple of weeks.

Gentlemen, again, thank you very much and I appreciate your time that you sacrificed today.

The Task Force is adjourned.

[Whereupon, at 1:49 p.m., the Task Force was adjourned.]

International Social Security Reform

TUESDAY, MAY 25, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12 noon in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Chairman SMITH. The Budget Committee Task Force on Social Security will come to order. For the purpose of today we have select witnesses talking about what is happening in some of the other countries around the world. The United States was the last of the developed countries to adopt a compulsory Social Security insurance program aimed at eliminating poverty among the elderly. Germany introduced its first plan in 1889, and now is still having a tremendous imposition of taxes on its citizens to fund its retirement program.

When Congress passed ours, the Social Security Act of 1935, the legislators looked to the examples provided by other countries to design our system. As we consider Social Security reform, we again have the opportunity to learn from experiences abroad. The demographic changes beyond the unfunded liability of our own system are a global phenomenon. Most European countries face even more alarming dependency ratios than we have in the U.S. and already have a higher payroll tax than we do.

In Eastern Europe, the average payroll tax is 40 percent. In Western Europe, the average payroll tax is above 20 percent, and some countries impose a tax as high as 70 percent.

All over the world, policymakers are considering and implementing reforms that bring stability to their Social Security systems. Chile inaugurated privatization with reforms adopted back in 1981. Australia implemented its own reform plan in 1987. Great Britain passed reforms in the 1980's, that moved that country to a partially privatized system. We can draw from the wisdom our global partners have gained through up to 20 years real time experience with reform, taking the best of their ideas and certainly learning from some of their mistakes.

Once we have learned from these examples, we can design a reform plan that will become a model for more of the other countries of the world, and being able to implement this program in this country is extremely important and time is definitely not on our side. The longer we put off reforms, the more drastic those reforms are going to have to be.

Representative Clayton, do you have a statement?

Mrs. CLAYTON. I don't. Again, we thank you for structuring these hearings and look forward to the witnesses' testimony.

Chairman SMITH. The other members', including our ranking member Ms. Rivers, statements will be entered into the record if they have one.

Our witnesses today are Dan Crippen, who has served as Congressional Budget Office Director since February 1999, has held senior policy positions in the White House and the U.S. Senate. He was chief counsel and economic policy advisor to the Senate majority leader from 1981 to 1985. In addition to his 10-year government career as an economic policy specialist, he has substantial private sector experience.

Estelle James, Estelle, welcome, is Lead Economist in the Policy Research Department at the World Bank and principal author of Averaging the Old Age Crisis: Policies to Protect the Old and Promote Growth.

Mr. Lawrence Thompson is a Senior Fellow at the Urban Institute, has spent his career dealing with education, income security and health issues. He served as Principal Deputy Commissioner for the Social Security Administration from 1993 to 1995 and as Assistant Comptroller General at the GAO from 1989 through 1993.

Mr. David Harris is Research Associate at Watson Wyatt Worldwide and advises and examines major international Social Security systems in Europe, Asia/Pacific, North and South America, certainly Australia. David was awarded the 1996 AMP Churchill Fellowship to research what influences public confidence in life insurance and superannuation in various international markets. He has worked as a consumer protection and superannuation regulator in the United Kingdom and Australia during the 1990's.

We thank you all for taking the time to come to this hearing and share your ideas, thoughts and recommendations with this Task Force.

Mr. Crippen, what we will do is any written testimony you have will be totally included in the record and we would ask you to limit your introductory comments to approximately 5 minutes so that we have maybe a little more time for questions. Mr. Crippen.

STATEMENT OF DAN CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. CRIPPEN. Thank you, Mr. Chairman. Actually, I hope to be able to beat your mark and offer about 3 minutes' worth of comments and look forward to the questions.

The report that brings us here today is the Congressional Budget Office's (CBO's) report on the experiences of five countries with privatizing their social security systems. That report is the basis for the remarks I am about to make. It was written principally by Jan Walliser, an economist who is now at the International Monetary Fund (IMF), and was released by CBO in January, just before I arrived.

The aging of the population, as you stated in your opening remarks, Mr. Chairman, is not unique to the United States. Most developing countries are experiencing growing retirement populations that we supported by fewer workers. Those facts mean, in part, that traditional pay-as-you-go pension and health care programs for retirees will be strained. Other countries have, and the United States is considering, reforms to those programs to help ensure future benefits and ease the burden on future workers.

Judging the desirability of reform—indeed judging the results of other countries' reforms—depends on at least two related questions: Can the reform help economic growth? And can the reform reasonably be expected to work? The first question I would submit, Mr. Chairman, is critical. It is ultimately the size of the economy that determines our ability to support a growing elderly population with fewer workers. Increasing national savings should enhance productivity and thereby economic growth. Increased savings can result from funding a previously unfunded pension system.

The second criterion is meant to include considerations of practicality, ease and cost of administration, protection against severe losses, and the extent of regulation.

Our comparisons of the five countries, Mr. Chairman, suggest the following observations. First, none of the five countries successfully maintained permanent funding of their government-run defined benefit system. Second, privatization has probably increased national savings and economic growth in the countries we examined. Third, administrative concerns, including costs of administration, do not appear to be insurmountable.

Mr. Chairman, the details of any reform are important, and the United States is vastly different from any of the countries examined here, but we are all bound by one truth: the larger the economy, the easier it will be to meet our obligations to future retirees. The experience of the five countries suggest that privatization can help.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Crippen follows:]

PREPARED STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and members of the committee, I am pleased to be with you this morning to discuss the lessons from the experience of other countries that have reformed their Social Security systems at least in part through privatization.

The retirement of the baby-boom generation in the United States will put our Social Security program under financial pressure, and a debate is now proceeding about how to pay for retirement in a financially sound way. Many recent proposals would allow workers to invest some portion of their earnings in personal retirement accounts. The amounts accumulated in those accounts would replace some of Social Security's benefits. Because some of a worker's retirement income would come from savings in his or her account rather than from government transfers, such plans would partly privatize Social Security.

Other countries face the same demographic and financial pressures as the United States. In fact, for many countries, the pressures are much more severe and immediate. Some countries have already responded to those pressures by privatizing their public pension systems to some extent, and their experience can offer lessons for the design of privatized pension systems. The economies and pension systems of those countries differ considerably from those of the United States, however, and comparisons should therefore be made cautiously.

The Congressional Budget Office (CBO) released in January a paper that reviews the experience of five countries—Chile, the United Kingdom, Australia, Argentina, and Mexico—that have introduced individual accounts to fully or partly replace their public retirement system.[1] Such plans are defined contribution plans—that is, retirement income depends in part on the uncertain returns on contributions to the accounts. Some other countries have relied on more traditional measures to close the financing gap, such as changing benefit rules and retirement ages or increasing payroll taxes, but those countries were not included in our analysis.

All five countries already had some type of old-age income support system before reform. Those systems relied primarily on "pay-as-you-go" financing, in which taxes collected each year mainly or entirely finance the benefits paid to retirees in the same year. For example, in the United Kingdom (U.K.), a payroll tax finances the government's expenditure for pensions (and other benefits) in the same year. Before reform, three of the other countries also generated most of the revenue for their pension systems by earmarked taxes on wages.

By contrast, a system with personal retirement accounts can prefund retirement income by requiring people to accumulate savings during their working years. For example, Chile's system requires workers to invest in personal retirement accounts from which workers may withdraw money only after they retire. Moving from a pay-as-you-go system to a prefunded private system, however, imposes a financial burden on transitional generations.

All five countries encountered the same set of issues in privatizing their systems, and those issues are also relevant to efforts to privatize the U.S. Social Security system.

- Policymakers have to decide who will pay for the transition between the pay-as-you-go system and a prefunded system. The transitional generation must continue to support retirees under the old system while saving for their own retirement. That issue is obviously not unique to privatization and must be faced in any reform of Social Security that moves toward a prefunded system.
- Some countries have required workers to shift to a new system of private accounts, and others have allowed workers to choose whether to join the new system or stay in the old pay-as-you-go system. Allowing choice can mean that the pay-as-you-go system lingers on and may (as in the United Kingdom) entail some additional administrative problems. But it can also help workers accept the change, particularly older workers who have substantial accrued benefits.
- Policymakers must decide whether to offer minimum benefit guarantees and how generous the guarantees should be. Without such guarantees, some people risk not having adequate retirement income. Making such guarantees, however, imposes a contingent liability on future taxpayers.
- Countries must decide how to regulate investment choices in the retirement system and how the retirement funds may be used. Regulation may be needed to limit fraud and risk—both the risk to retirees if investments turn sour and the risk to taxpayers if the plan guarantees minimum benefits. Regulations about how the retirement funds may be used, such as conditions for withdrawal and whether annuities would be mandatory, are also important. However, regulations also limit an individual's choice about investment and retirement.

Types of Privatization Plans

The countries we examined followed one of three major models in privatizing their pension systems. Chile, Mexico, and Argentina used a model in which workers establish private retirement accounts. The United Kingdom allowed its workers to choose between the old pension system and the new system. Australia based its system on employers' contributing to retirement accounts for workers.

THE CHILEAN MODEL

Chile, a pioneer in privatization, replaced its pay-as-you-go system with a system based on private retirement accounts in 1981. New workers had to establish private accounts. Workers already in the old system could choose to remain there or switch to the new system and earn a more attractive expected return on future contributions. To encourage switching, the government compensated workers who did so with "recognition bonds" that would be paid into a worker's account at retirement. Workers with sufficient years in the system were guaranteed a minimum retirement income of about 25 percent of the average wage. Obligations to existing workers were financed with general revenue and debt (the recognition bonds).

Mexico and Argentina generally followed the same model as Chile, with some modifications. In Mexico, for example, all workers have been required since 1997 to join the new system and save in private accounts. At retirement, however, workers

[1] See Congressional Budget Office, *Social Security Privatization: Experiences Abroad*, CBO Paper (January 1999).

who have contributed to both systems may choose to receive benefits from either system (but not both). Argentina has both benefits that are financed on a pay-as-you-go-basis (similar to those in Social Security) and private retirement accounts. People who choose to contribute to private accounts receive an additional pension that reflects their contributions to the old system (like the recognition bonds in Chile).

THE U.K. MODEL

The United Kingdom, when it began its reforms in 1986, followed a different model. Its existing retirement system already had a privatizing option; that is, people whose employer offered a pension were allowed to opt out of part of the government's pay-as-you-go system. Those who did so received a rebate on their payroll taxes. The reform simply extended that option by allowing workers who set up a personal pension plan to opt out as well. Transition costs are financed out of general revenue (possibly including debt) and by reduced benefits in the government system.

THE AUSTRALIAN MODEL

The third model is that of Australia, which chose to base its reformed system on employers by requiring most of them to contribute to workers' retirement funds. Unlike the other four countries, Australia never had a Social Security-like system funded by earmarked contributions. Instead, the government used general revenues to pay for a means-tested pension that was not regarded as an entitlement. Because the old system lacked a specific entitlement, it did not require the government to compensate workers for any benefits accrued under the old system. However, if the reform succeeds in replacing the government pension, it will be true in Australia, as in the other countries, that one generation will pay for their parents' as well as their own retirement.

DESIGN ISSUES

The experiences of the countries that have already begun their reforms highlight the importance of the design of the new pension systems. Our analysis revealed three issues: the need for additional information if a complex system is to work; the need to regulate investment choices; and the need to regulate withdrawals from the accounts.

INFORMATION REQUIREMENTS OF A COMPLEX SYSTEM

The reform in the United Kingdom demonstrates the difficulties that can arise if the new system offers workers a large array of choices and decisions to make but does not ensure that the worker has sufficient knowledge to make informed decisions. In the U.K. case, figuring out whether they should stay in their employer-based plans or switch to the newly available private accounts was difficult for many workers. If they switched, they would lose accrued benefits in the employer plans but would gain a more attractive return in the private accounts. Under pressure from sellers of the private accounts—including, apparently, some fraud—some workers made poor decisions. The United Kingdom responded to that problem with more careful regulation. Sellers of private accounts now have to provide enough information to enable workers to make a reasonable decision.

REGULATION AND RISK

Regulation of investment choices within the private accounts differs among the five countries. Such regulation could be important to protect either retirees or taxpayers, who in many cases are on the hook to finance a minimum benefit guarantee if investments in the accounts prove to have been unwise. One would expect, therefore, that systems that guarantee a minimum benefit would tend to have more regulation, though that is not always the case.

Neither the United Kingdom nor Argentina has a contingent minimum benefit. A worker whose investments went sour (and who had worked long enough to qualify) would have to rely on a basic pension that was not means-tested. The basic pension therefore does not depend on how successful the worker's investments are. The possibility of poor returns in the private accounts does not explicitly impose any risks on taxpayers. Of course, taxpayers still have to pay for the basic pension.

By contrast, the basic pension is means-tested in Chile and Mexico. Workers in those countries can choose their investment portfolio. (Australia also has a means-tested pension, but employers generally choose the portfolio.) Consequently, workers in Mexico and Chile have an incentive to invest in risky assets offering high expected returns—the worker reaps all the benefits if the gamble pays off and can rely on the basic means-tested pension if it does not. Taxpayers in those countries thus have a greater interest in ensuring that returns on the private accounts do not fall too low. (Means-tested pensions can also have other disadvantages: for example, they can reduce incentives to work and save.)

The taxpayer thus bears part of the risk of poor investment choices in Chile, Mexico, and Australia but not in the United Kingdom or Argentina. One would therefore expect the United Kingdom and Argentina to have little regulation and the others to regulate investment choices more closely. As expected, regulation of investment choices is minimal in the United Kingdom, consisting mainly of the ordinary "prudent man" fiduciary standard, and is quite stringent in Chile and Mexico. The odd couple are Australia and Argentina. In Australia, taxpayers bear some of the risk of the accounts, but regulation is as light as in the United Kingdom. In Argentina, by contrast, taxpayers do not bear that risk, but regulation is as heavy as in Chile, which has in other respects also been a model for Argentina.

REGULATION OF WITHDRAWALS

In Australia, workers can "game" the system by withdrawing all their money from the accounts at retirement and spending it, for instance, by paying down their mortgage or buying a new house. Housing receives special treatment under the rules for the means-tested pension. Currently, most people qualify for the pension. If that practice continues, the reform will have made almost no difference in the government's costs for retirement. Australia's experience suggests the importance of establishing rules that govern when, how, and for what purpose funds may be withdrawn from the accounts. Many proposals for reform in the United States, for example, prohibit lump-sum withdrawals and require workers to purchase an annuity at retirement. Having such rules would avoid the problem Australia encountered.

ADMINISTRATIVE COSTS

Most analyses of the administrative costs associated with proposals to privatize pension systems examine the cost of managing private accounts. That is, of course, only one part of the cost of a proposal; both the current Social Security system and any reformed system also impose administrative and accounting costs on employers and workers. CBO is now conducting a more detailed study of administrative costs in a privatized system.

Comparing the administrative costs of managing private accounts for the five countries is quite difficult. Some plans take out administrative costs as an initial payment at the time of investment, and other plans charge an annual fee. The different fee mechanisms preclude any direct comparison, particularly since most of the reforms are recent and the plans have not matured. Nevertheless, a couple of lessons have emerged.

First, fees and commissions of individual accounts appear to be close to what managed mutual funds charge for individual accounts in the United States. In Chile, account fees and commissions are about 1 percent of the assets held in Chilean pension accounts. A 1-percent charge is quite common for managed mutual funds in the United States. The large accounts in Australia that give limited choices to workers seem even less costly, with fees approaching those that index funds charge in the United States (about ⅓ percent of assets). In addition to managing investments, systems with individual accounts need to collect and maintain data in more detail and collect it more frequently than a large-scale public system without individual accounts. Such systems therefore tend to be more expensive than, for example, the U.S. Social Security system.

The second lesson is that design choices seem to affect management costs. In Chile and the United Kingdom, for example, funds are marketed directly to individuals, which leads to relatively high sales costs and little bargaining power for purchasers. In addition, workers in Chile can switch funds several times a year, and workers in the United Kingdom can contribute sporadically and to several small accounts. All those factors increase total administrative costs. In Australia, by contrast, companies representing many individuals and contracting on a more stable basis face much lower fees.

NATIONAL SAVING

All of the reform plans hoped to reduce strains on the government's financing of retirement and, by encouraging private saving, increase the national saving rate. That is an important goal because the only way that real resources can be put aside for retirement is through saving and capital investment in plant and equipment and human capital (education and training).

Because of limited information on what the governments and workers would have done had the pension systems not been reformed, estimating the reforms' exact impact on national saving is difficult. In the United Kingdom, the fiscal tightening associated with pension reform indicates that the government offset little if any of the additional private saving in personal retirement accounts. In Chile, a fall in government saving probably offset only a portion of the increased private saving. As a result, Chile's national saving rate may have increased by 2 percent to 3 percent of gross domestic product (GDP). In Australia, estimates indicate that under certain behavioral assumptions, the reform might increase national saving by about 1.5 percent of GDP in the long run. The saving effect of reforms in Mexico and Argentina cannot yet be ascertained; however, the gains in national saving are probably less in Mexico and Argentina than in Chile.

Another important lesson from the countries we studied is the difficulty of funding a retirement system controlled by a national government. Several of the countries intended to fund or partially fund their systems over time. However, in each case the good intentions were overcome by demographic pressures and the ease with which trust funds can be deployed for other purposes. A motivating force for privatization may have been the failure of the national governments to establish and maintain a cache of assets in a trust fund as we commonly understand it.

CONCLUSION

The aging of the population is not unique to the United States—many countries are experiencing growing retirement populations supported by fewer workers. Those facts mean, in part, that the traditional pay-as-you-go pension and health care programs for retirees will be strained. Other countries have undertaken, and the United States is considering, reforms to those programs to help ensure future benefits.

Judging the desirability of reform—indeed, judging the results of other countries' reforms—depends critically on at least two related questions: Can the reform help economic growth? And can the reform reasonably be expected to work?

The first question is critical. It is ultimately the size of the economy that determines our ability to support a growing elderly population with fewer workers. Increasing national saving should enhance productivity and thereby economic growth. Increased saving results from funding a heretofore unfunded system with real assets, not with increases in government debt.

The second question addresses considerations of practicality, ease and cost of administration, protection against severe losses, and the extent of regulation.

Our comparisons of the five countries suggest that:

- None of the five countries successfully maintained permanent prefunding of their government-run, defined benefit pension system.
- Prefunding through privatization offers an opportunity to increase national saving and economic growth.
- Administrative concerns, including cost, do not appear to be insurmountable, but the details are important.

Chairman SMITH. Ms. James.

STATEMENT OF ESTELLE JAMES, LEAD ECONOMIST, POLICY RESEARCH DEPARTMENT, WORLD BANK

Ms. JAMES. Hello. I was asked to talk mainly about how other countries have covered transition costs and also the issue of administrative costs. So I will focus on those two issues.

Let me just say, though, on the issue of economic growth, which Dan Crippen just referred to and which I agree, is crucial: Only one country has had experience long enough really to do empirical studies on the impact on savings, financial markets and growth, and that is Chile. The preliminary evidence we have from Chile is encouraging, although, of course, we will have to do many more studies over many more years to know for sure what the consequences are. But so far, the consequences seem to be positive for savings, financial market development, and growth.

Now on the issue of transition costs and administrative costs, we basically have two models of reform around the world. There is the

Latin American model, where there are individual accounts and where there was basically what we might call a carve-out; that is, money was diverted from the old system to the new system. And then we have the OECD model, which features group choice and in most countries was an add-on. Where you have an add-on, you don't have the transition cost issue but in the Latin American countries you did have the transition cost issue.

Latin American countries covered transition costs in a variety of ways.

1. Downsizing the old system, but always very gradually in a way that does not affect current pensioners because you know for sure if you cut benefits of current pensioners it is unfair and you will have tremendous political opposition that will doom the reform.

2. These countries have kept part of their systems pay-as-you-go by keeping older workers in the old system and by retaining a pay-as-you-go pillar in the new system; all the various proposals that we have in the U.S. include that kind of idea. That cuts the transition costs, the financing gap.

3. Countries have used other revenue sources, such as a surplus in the treasury, or a surplus in the Social Security system, or privatization assets. Now we don't have privatization assets but we do have a surplus. Chile in particular has used that method to finance the transition.

4. Finally, practically every country has used some debt finance to help the country over the crunch in the first few years. We can anticipate a long-term fiscal saving, but there may be a period in the beginning and in the intermediate stage where there would be a fiscal deficit, and most countries have used debt financing as part of their plan for covering that deficit.

The idea is you spread the burden out over many generations, so it is not true that one generation bears a double cost, and then some of the younger people who reap the benefits of the reform also pay some of the costs. So I think that is a lesson that is relevant to the U.S. We shouldn't be afraid of a little bit of deficit financing, if that is necessary as parts of a larger reform program.

Now, on the issue of administrative costs, as you all know that is one of the most critical issues and one of the most controversial issues. Chile has been criticized for the high administrative costs of its individual account systems. In fact, this is an issue that, with my colleagues at the World Bank, we are now investigating very closely. So far what we have found is both good news and bad news. The good news is that fees and administrative costs in Chile are not as high as is sometimes believed. You hear numbers like 15 or 20 percent thrown around but actually it is 15 or 20 percent of your incoming contribution and once you have paid that fee you don't pay any other annual fees on that particular contribution for the rest of your life. If you average that cost out as an annual percentage of assets, over the lifetime of a full career worker, it turns out to be less than 1 percent. It is around 70 basis point depending upon the assumptions that you make.

So compared with other financial institutions, this is actually a pretty good deal.

On the other hand, it does reduce benefits by 15 or 20 percent compared with a system where there were no costs. So it is something that we have to think about, but it is not as prohibitive as sometimes appears.

Now the second thing we found is that if you look at mutual funds in the U.S., which we used as a basis for comparison, the costs are actually on average somewhat higher than those in Chile, and in both cases marketing costs were a large share of the total. We infer from this that in retail financial markets you are likely to have high marketing costs, and if there is a way of setting up a system to avoid those marketing costs this would benefit the workers ultimately.

Now, when we looked at the costs of institutional investors, we found—in the U.S. again—we found that the costs are much less than for the retail mutual funds, largely because the marketing costs in that sector are much lower. We infer that the challenge in setting up an individual account system is how to set it up in such a way as to benefit from those institutional rates.

Chile did not do that, but other countries are trying to do that. For example, Bolivia used a bidding process to auction off rights to run the individual accounts to two firms in an international bidding contest, and their costs appear to be about half those in Chile.

Sweden is using a negotiated fee ceiling to try to keep the lid down on costs, particularly marketing costs, and we will be watching carefully to see how that actually works.

So the lesson is that how you set up the individual account system matters. The costs in the Latin American model are not as high as is sometimes said, but I think it is possible to do better.

Thank you.

Chairman SMITH. Thank you. Mr. Thompson.

STATEMENT OF LAWRENCE THOMPSON, SENIOR FELLOW, URBAN INSTITUTE

Mr. THOMPSON. Thank you. I am going to address myself entirely to the administrative aspects of individual accounts, and if I can leave you with one thought it is this: that no one in the world has implemented a scheme which I think would be acceptable in the U.S. That doesn't mean it can't be done. But, you have to be very careful in looking through the various trade-offs that are involved. The risk is that you will adopt a policy thinking that the administrative details can be worked out when they can't be worked out in a way that is acceptable. I will develop that point if I could for a second.

First of all, in a number of ways, the U.S. is different from almost everybody else who has tried to do individual accounts. First, we don't start with a clean slate. When we talk about individual accounts in Social Security, invariably we liken them to 401(k)s and other kinds of instruments which already exist in this country. We evoke in people's mind an image of what individuals accounts in Social Security will look like and how they will operate. People's expectations are going to be upset if what actually emerges is a good deal less attractive than 401(k)s.

Secondly, we seem to have ruled out certain options which I think are promising options in other contexts. Specifically we seem to have ruled out employer mandates, which is how Australia and Switzerland have created individual accounts at reasonable cost. There are trade-offs involved in employer mandates. We seem to have ruled discussion of those trade-offs out of our current political debate. We are not going to increase the burden on employers, so we have closed off the employer mandate option.

Third, most of the individual account proposals in this country deal with a pretty small contribution rate. I have a table in my statement that compares how individual accounts operate in several countries. You will notice that Sweden is the only one which has a contribution rate anywhere near that rate discussed here. Their contribution rate is 2.5 percent contribution rate. Most of the conversations in this country are in the neighborhood of 2 percent. Most other people are dealing with two and three and four times as much, which means the accounts are much larger in those other countries than they are here.

Lastly, we are not talking about dividing up an Eastern European huge single pillar that tried to finance the entire retirement. We are talking about making adjustments to what is already a two-pillar system that has a significant amount of private pension in it.

Well, I say that the devil is in the details and it is doubly true in the case of individual accounts, and so I lay out five objectives that people seem to have when they advocate individual accounts, and I talk through what the difficulties are in achieving each of these objectives with the idea of leaving you with the notion that there is no clear magic bullet here.

The first objective is to provide workers with a reasonable rate of return, which seems to be the number one rhetorical point made in the debate in this country. Estelle has talked about the administrative costs in the Latin American systems, and I think she has probably given accurate figures with respect to the costs of managing the funds. She has not talked about the costs of annuitizing them when you are done, and if you add together the annuity costs and the management costs you easily get to a situation where you are spending 1 percent of your gross domestic product running a pension system.

The most recent estimates out of the UK are that 40 percent of the money that was in the personal accounts gets dissipated into administrative charges and fees. The numbers in Latin America are closer to maybe a quarter.

Sweden is trying to implement an alternative which, as Estelle says, hopes to get rid of the marketing costs and negotiate lower fees. The jury is out about whether they can actually do it or not. They have run into some problems. We can discuss that, if you like.

Now, on the other hand, most of these countries that have gone to these individual accounts have done so for a reason, and that is that they don't trust central management of the funds, or they have had bad experiences or something. And so if you are in a position where the choice is between central management you don't trust and incurring administrative costs that are rather high, maybe you take the administrative costs. You have to pick your poison, though. You are likely to get burned either way, or you run the chance of being burned either way.

Secondly, we want to make sure that the contributions are handled responsibly and that they are not invested in a risky way. I am struck by the fact that the administrative process, as used in most of these countries, do not take the care that we are used to having in making sure that money gets posted to the right account. In the end, each employee has to check his statement to make sure that his money got there because no one is double-checking, matching account numbers and names and so forth, which is the policy in the U.S. before we post accounts.

It is also the case though that many of these other countries, not counting the United Kingdom, have fairly tightly regulated their investments and probably have minimized the odds that people will lose their money in risky investments. Some of the proposals in the U.S. do not have that feature, and that needs to be examined carefully.

Third, we want to provide workers with choice. In the UK system, although it is terribly expensive, it does do a good job of providing workers with choice. The Latin American systems don't do a very good job of providing workers with choice because for a complex set of reasons they end up producing a set of choices in which everybody is offering the same portfolio, or almost the same portfolio. So the choice is more apparent than real.

In the U.S. debate, there are people who advocate some variation on the Federal Thrift Savings Plan, which allows a very sharply constrained choice but at least allows some choice between two or three or five portfolios. And the hope is that that choice will be enough choice but can be done in a way that will not involve unreasonable administrative costs.

I already mentioned a fourth objective, which is to not impose an increased burden on employers, which seems to have ruled out the Australian and Swiss models from our debate and probably also rules out the mechanics of how most of the Latin American models work because they all work on monthly reporting, and we have annual reporting in this country.

We used to have quarterly and we went to annual to reduce the burden on employers. I am not sure you want to go back to multiplying by 12 the number of reports that each employer has to file to make an individual account system work.

But once you go to annual reporting, you introduce a whole new feature, which is that you have big time lags between when the money is taken out of the worker's paycheck and when it actually makes it into the individual accounts, as much as 18 to 24 months, which is not the way the Federal Thrift Plan works. So I alert you that when you use the Federal Thrift Plan model for Federal workers that money goes into the account they selected as soon as it is taken out of their paycheck. You can't operate that kind of a model across the country on a national basis. You are going to have big time lags. Nothing necessarily wrong with that, but you have got to be up front with people about what you are actually proposing.

Lastly, insulate the economy from inappropriate political interference. There is a lot of concern in this country that if the central fund was held in equities, or a chunk of it was held in equities, that the Congress would get their fingers in there dictating about what securities should be divested and that there would be issues of who is going to vote those shares and so forth. I only point out that a Federal Thrift Plan model has essentially the same set of problems because there is a block of assets and they are being held centrally even though they are being held nominally in individual accounts. Somebody has got to figure out how to vote the shares and the Congress can dictate what is going to happen in the future to tobacco stocks.

So those are the kind of issues you have to work your way through. There is no good answer, and it is important to consider carefully what the trade-offs are.

[The prepared statement of Mr. Thompson follows:]

PREPARED STATEMENT OF LAWRENCE H. THOMPSON, SENIOR FELLOW, THE URBAN INSTITUTE

Many advocates of individual Social Security accounts implicitly assume that an acceptable strategy can be developed for implementing their plan. International experience suggests that this is a dangerous assumption. No country has yet successfully implemented individual accounts in a way likely to be acceptable in the U.S. Supporters of individual accounts need to pay more attention to administrative details if they want to avoid another catastrophic health fiasco.

One of the most contentious elements of the current debate about refinancing Social Security is whether to introduce a system of mandatory individual investment accounts. This part of the debate ranges across a variety of considerations. These include likely impacts of one or another course of action on: benefit adequacy, benefit predictability, rates of return to Social Security contributions, the progressivity of the retirement income system, the behavior of future political office holders, competing social philosophies, the macro economy, and the future fiscal position of the Federal Government. With so many dimensions to discuss, it is a debate that could go on for a long time and become quite confusing.

Most of the attention so far has been on policy trade-offs. They are important and should be thoroughly analyzed and debated. But, people who are serious about creating mandatory individual accounts must also focus on the practical aspects of how such accounts can be administered. Administration of these accounts is a case where the devil is truly to be found in the details. In this regard, a number of countries have created mandatory individual accounts of one form or another, and it is my belief that none of them has yet devised an administrative structure and strategy that is likely to be acceptable in the United States.

THE COMPETING OBJECTIVES

Constructing a national system of individual accounts involves important choices which require balancing competing objectives. Quite likely, no structure can be devised that will achieve of the objectives fully. The challenge of somebody trying to design an individual account proposal for the United States is to decide which objectives to sacrifice in the interest of achieving others.

An outline summary of the different models proposed or implemented around the world is attached. The rest of this statement will concentrate on the competing objectives and the challenges in achieving them.

Among the important objectives that individual account systems are designed to achieve, five stand out:

1. PROVIDING WORKERS WITH A REASONABLE RATE OF RETURN ON THEIR MANDATED CONTRIBUTIONS

Particularly in the U.S., the case in favor of individual accounts almost invariably begins with the assumption that they would provide a higher return than does the traditional Social Security program. Getting decent returns, however, requires keeping administrative costs at reasonable levels and assuring that investment decisions are guided only by concerns of maximizing returns at acceptable risk. Experience elsewhere suggests these are more easily said than done. Administrative costs are the Achilles Heel of all of the decentralized individual account systems currently in operation around the world. In the Latin American systems, roughly one-quarter of the money that goes into the funds is lost to administrative fees. In the U.K., administrative charges are averaging 40 percent of the system's resources. Before long, these countries will find that they are spending more than 1 percent of their GDP just to administer their pension systems. Australia and Switzerland have managed to avoid such high administrative costs by relying on employer-sponsored accounts rather than allowing the complete decentralization found in Latin America and the U.K. Sweden is trying to implement an alternative arrangement designed to avoid the administrative cost problems found in Latin America and the U.K., but the Swedes have encountered some practical problems and their system is not yet operational.

The costs associated with decentralized administration of the system must be weighed against the possible loss of returns if funds are held in a form and in a place where political interference can produce poor investment returns. One study tracking returns paid on accounts in the provident funds of Malaysia and Singapore concludes that they fell short of the market returns available elsewhere in the respective countries by an amount roughly equal to the administrative charges found in Latin America. Apparently you get to pick your poison.

2. ASSURING THAT CONTRIBUTIONS ARE HANDLED RESPONSIBLY AND THAT EXCESSIVELY RISKY INVESTMENTS ARE AVOIDED

I am struck by several differences between the administrative processes used in public pension systems in the U.S., Sweden (and other OECD countries I have studied) and the processes used in other parts of the world. One of these differences has to do with the care taken in accounting for the money withheld from worker's paychecks. In the U.S., one of the most burdensome aspects of the earnings posting process involves double checking everything to make sure that the right amount was reported by the employer and that it is going to the right account. Something like one out of every ten earnings reports has errors that need to be followed up. The Latin American individual account model embodies comparatively little of this care. In that model, reports of contributions flow into the system each month and are pretty much processed as they are received. In the last analysis, each worker must check his or her investment statements to make sure that their money really did get deposited correctly and must take the initiative to resolve any discrepancies that may arise when mistakes are found. That the Latin Americans do not check the data as closely as we do is more a reflection of the intrinsic character of the model than of the quality of their implementation. They are collecting information on each employee's contributions each month. I doubt that it is possible for any institution to process that much information every month and still run as many cross checks as the U.S. uses to process its information.

On the other hand, the Latin American model tightly regulates the kinds of investments that pension funds can undertake. Once the money makes it to the fund, the odds that it will be lost to excessively risky investment are minimized. In contrast, some of the proposals that have been made for the U.S. seem to be structured to encourage workers to invest in the riskiest assets possible. This is the logical result of guaranteeing current law benefits to those whose investments didn't work out.

3. PROVIDING INDIVIDUAL WORKERS WITH A REASONABLE DEGREE OF CHOICE ABOUT HOW THEIR MONEY WILL BE INVESTED

Presumably, one of the advantages of individual accounts is the ability of workers to exercise more control over their retirement nest egg. Obtaining this advantage requires, however, that they be allowed some choice about investment forms and strategies.

Choice costs money. Though the U.K. system is expensive to operate, it does give each participant a wide choice of investment instruments. On the other hand, the Australian system has been criticized for not guaranteeing choice to workers. Australia is currently debating whether to mandated that each worker have at least four options, but pension providers warn that administrative costs would rise as a result.

On the other hand, spending lots of money doesn't guarantee a meaningful choice. The Latin American systems give participants little real choice about investment strategies. Owing to the structure of the guarantees built in to those systems and the regulatory strategies, every competing pension provider holds essentially the same portfolio of assets.

The Thrift Savings Plan model in the U.S. represents one attempt to balance choice and costs. Choice is provided, but it is sharply constrained by being limited to a handful of indexed funds that are defined by the plan but managed by private firms. To date, this has proved to be about the most efficient way to offer at least some degree of choice. But it requires a far more direct role for government in operating the system than many of the designers of systems in other countries would be comfortable with.

4. AVOIDING AN INCREASED BURDEN ON EMPLOYERS

Public policy in the U.S. is more sensitive to sparing employers undue burden than any other country I know. Many countries require all employers to file information electronically; those that do not require electronic filing at least require employers to file on standardized forms. We do neither.

The Australian and Swiss systems of individual accounts are administered fairly efficiently, but they are examples of are model that has been proposed and rejected in this country. Each is a variation on the Mandatory Universal Pension System (MUPS) plan proposed by President Carter's Pension Commission and rejected owing to the desire to avoid any further employer mandates.

The Latin American model also requires monthly reporting of every individual's earnings and contributions. In the U.S., we used to require such reports to be filed quarterly, but we reduced the frequency to once a year to lighten the burden on employers. It is doubtful that we would adopt a system that relied on monthly reporting by employers.

The price paid for avoiding monthly reporting is that the resulting system has major time lags built in. For example, both the U.K. and Sweden require only annual reports from employers. In both cases, therefore, the money withheld from a worker's paycheck sits around someplace for up to 24 months before it gets transferred to the fund of the worker's choice. Presumably, we would have to adopt the same policy in the U.S. In effect, money withheld from your paycheck in January 1999 won't be invested according to your preferences until around September 2000. The Federal Thrift Plan does not suffer from time lags like these. In this respect, it is not possible to build a system of individual accounts in the U.S. that will look like the Federal Thrift Plan.

5. INSULATING THE ECONOMY FROM INAPPROPRIATE POLITICAL INTERFERENCE

A common fear voiced in the U.S. is that government ownership of a large portfolio of assets could give government undue influence over the economy through the influence it could exert on corporate management. Such concerns also helped convince the Swedes to adopt a more decentralized approach, more or less as a replacement for a more centrally managed fund that has been part of their Social Security program since the 1960's.

The governance problem is usually raised in connection with proposals to invest the current trust fund in private securities. Presumably, however, to the extent that the concern involves how shares are voted and whether a subsequent Congress mandates divestiture of certain assets, the concerns are equally applicable to a system of government-operated individual accounts under a modified thrift savings plan model.

THE CHALLENGE FOR THE U.S.

If the U.S. decides to create a system of mandatory individual retirement accounts, it will have to also develop an administrative strategy for organizing the system and a management strategy for running it. We should expect that we will have to make serious compromises from the ideal in developing both. The result will likely not be something that looks like today's 401(k) plans. Indeed, we will probably have to create an entirely new institution to implement an approach that had never before been tried anywhere in the world.

What we can learn from experience abroad is what not to do. We don't want the employer burdens that are associated with the Australian, Swiss and Latin American systems. We don't want the administrative costs associated with the U.K. and Latin systems (indeed, at the contribution levels most people are discussing here, we couldn't possibly afford them.) Instead, we want choice, we want security, and we want the politicians to keep their hands off of the funds. Now we just have to figure out how to do it.

SUMMARY OF INDIVIDUAL ACCOUNT PLANS

Plan	Latin America[1] (Chile)	Switzerland	Australia	UK	Sweden	CSIS[2]
General Characteristics:						
Is Participation Compulsory?	Yes	Yes	Yes	No	Yes	Yes
Contribution Rate	13%	7–18%	9%	4.8–5.8%	2.5%	2%

SUMMARY OF INDIVIDUAL ACCOUNT PLANS—Continued

Plan	Latin America[1] (Chile)	Switzerland	Australia	UK	Sweden	CSIS [2]
Budget Financing?	Transition	No	No	Partial	No	Partial
Who Collects?	Pension fund	Pension fund	Pension fund	Tax authority	Tax authority	Tax authority (IRS)
Who Remits?	Employer	Employer	Employer	Employer	Employer	Employer
Who Maintains Records?	Pension fund	Pension fund	Pension fund	Investment mgr	Government	Government
Employer Reporting Frequency	Monthly	Monthly	Monthly	Annual	Annual	Annual
Investment Management:						
Who Selects Investment Manager?	Worker	Social Partners	Employer	Worker	Worker	Government
Who Selects Investment Strategies?	Investment mgr	Investment mgr	Investment mgr	Worker	Worker	Government
How Many Options for Workers?	None	None	0–5	Unlimited	Unlimited	4 or 5
Maximum Time Lag	Days	Days	Days	18–24 months	18–24 months	18–24 months
Withdrawal of Funds:						
Lump Sum Withdrawal Allowed?	No	Up to 50%	Yes	Up to 25%	No	Limited
Annuities Mandatory?	No	Yes	No	Yes	Yes	No
Price Indexing Required?	Yes	No	No	To 3%	Not decided	No
Who Picks Annuity Provider?	Worker	Pension fund	Worker	Worker	Government	Government
Guarantees:						
Absolute rate of return?	No	Yes	No	No	No	No
Relative rate of return?	Yes	No	No	No	No	No
Minimum Benefit?	Yes	No	No	No	No	No
Prior Law Benefit?	No	No	No	No	No	No
Solvency of Investment Company?	Yes	Yes	No	No	No	Implicitly

[1] Similar approaches are followed in the other Latin American countries as well as Poland and Hungary; others tend to use government to collect.
[2] Proposal of the Center for Strategic and International Studies.

Chairman SMITH. Thank you very much.
Mr. Harris.

STATEMENT OF DAVID HARRIS, RESEARCH ASSOCIATE, WATSON WYATT WORLDWIDE

Mr. HARRIS. Thank you, Mr. Chairman, committee members. Thank you for the invitation today to discuss ostensibly the Australian, British and Chilean retirement systems, with particular reference to the individual retirement accounts.

My comments today will mainly dwell on the Australian model as such, but also will make observations on the British and Chilean approach retirement reforms.

As a former regulator who has worked in both Australia and the United Kingdom, where I critically evaluated existing and planned Social Security reforms, I think the importance of international comparisons in shaping the public policy debate concerning Social Security reform is especially important.

It should be stressed that as has been commented by previous speakers, that no one particular international model that I will talk about today can be used as a template for Social Security reform in the United States.

Yet the experiences of Australia, Chile and the United Kingdom certainly help resolve or dispel what I call the Chicken Little mentality of individual accounts related to Social Security. That is that individual accounts simply can't function and function effectively with regard to administrative costs, for example.

What is striking about the Australian system is that political pressures are the reverse of those in the United States. It was a Federal labor government, if you like it, a democrat leaning government, that largely introduced the system in 1987 and then reformed it in 1992. This policy was not only supported by organized labor but also was actively encouraged by the leadership of the Australian Council of Trade Unions, if you like the AFL–CIO version in the United States.

Businesses and consumer groups also backed the changes. Such a unified approach to reforming Australia's superannuation system, or pension system, was due to possible fiscal concerns about the impact of an aging population on Australia's economy.

Moreover, organized labor argued that the coverage of superannuation which had been narrowly confined, if you like, to a relatively affluent 40 percent of the workforce should also cover all workers through compulsory employer contributions.

The consensus was to create a retirement system with three distinct pillars. The first pillar is a means tested, pay-as-you-go, unfunded Old Age Pension. Full pension payments equate to only 25 percent of MTAWE average weekly earnings, with revenue being generated from Federal taxation and provided out of consolidated revenue. In recent years, this benefit has been means tested by strong income and assets tests.

The second pillar is a mandated individual account based system which receives currently 7 percent of an employee's salary in excess of $450 Australian per month, roughly $230 U.S. The concentration level will eventually rise to around 9 percent by 2002. Additionally, what is important to stress, Mr. Chairman, is that workers are voluntarily contributing today, as in tomorrow, 4 percent of their salary on a voluntary basis into these accounts. Largely these accounts exist on an employer sponsored, defined contribution basis, but it is important to note that individuals can seek and do purchase individual superannuation retirement accounts from life insurance and fund manager providers.

Workers can choose professionally managed equity or bond funds, fixed income securities or a mix. I think it is important to note that the third pillar sees again individual retirement accounts created on a voluntary basis with contributions largely received through savings rebates and taxation.

I think what is important to note about the Australian superannuation approach is that it doesn't involve government control to any great extent with regard to investing monies on behalf of individual account holders as seen possibly in Chile. Except for the normal standards of regulation associated with disclosure and prudential solvency, fierce and effective competition between industry participants has effectively driven down the fees and increased returns, so that administrative costs, and this is an important point to stress, as a percentage of assets on the management has fallen to the range of 69 to 83 basis points in 1997 in Australia.

If you are in Australia today, you can effectively purchase and pay for a superannuation account and pay roughly fees and charges of about 66 cents U.S. per week, and that is an important point to note, that administrative costs are continuing to decline as the system matures.

Contrary to what is often argued in the United States, even the small account holders in Australia can minimize charges and maximize returns. For women and disadvantaged groups especially, responsive superannuation accounts have developed that take account of seasonal or broken career patterns. To reach these groups, the government has had a rigorous program of public education, which begins with those who need to be made aware of how the plan effectively is structured for their retirement and their individual responsibility.

Quickly, to move to effective regulation, which is often a concern with some of the Social Security models, particularly Chile and the UK, what Australia did clearly was identified that consumer protection or minimizing consumer protection risks had to be enshrined through legislation and in Australia we adopted much of the SEC regulations, which has meant that large scale mis-selling, as in the format or the form that has occurred in the United Kingdom, has been effectively minimized.

In effect, the long-term retirement outlook for Australians living on Main Street appears promising.

Just quickly, I would like to make some comments about Chile and the UK. I think Chile's approach is that back in 1991 they didn't have much of an alternative. Their effective pay-as-you-go system was effectively becoming bankrupt. I think they initiated a bold system of contributions, and I think considering the development as has been described by Estelle James with regard to the capital markets, I think it has been very, very strong and very effective. The concern obviously has administrative costs but also the consumer protection detriment.

I think the UK is interesting. What is important to note with the UK is that pension funds as a percentage of assets as a percentage of GDP in the UK, it is about 77 percent. So clearly the UK has a strong and effective retirement record with regard to provisioning.

I think the UK today through the Blair government is adopting a planned Social Security model through the stakeholder pension that will see individual defined contributions likely to be enshrined by 2001.

So in summary, Mr. Chairman, and committee members, I think it is important to note that today and tomorrow, as in tomorrow, individuals in Australia, Chile and the UK will be exposed less and less to the vagaries of political risk associated with their long-term retirement nest eggs.

Through providing the necessary infrastructure, all three countries are benefiting from empowering their citizens to be proactive with regard to their retirement savings and also minimizing the long-term liabilities linked with the retirement of the baby boomer generation in the next century.

Thank you.

[The prepared statement of Mr. Harris follows:]

PREPARED STATEMENT OF DAVID O. HARRIS, RESEARCH ASSOCIATE, 1996 AMP CHURCHILL FELLOW, WATSON WYATT WORLDWIDE

The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Mr. Chairman, I am pleased to appear before the Budget Committee's Task Force on Social Security to broadly discuss the Social Security reform experiences in Australia, Chile and the United Kingdom. All three countries have shared since the beginning of the 1980's a political and economic will to "grasp the thorny nettle of Social Security reform." The successes and otherwise of these international Social Security models provides a useful "blueprint" for the United States in its ongoing discussions over the future of Social Security reform. My testimony will largely concentrate today on the experiences generated by Australia in moving toward a more fully funded approach to its retirement needs, in the late 1980's and early 1990's. Additionally details are provided on the Chilean and British Social Security reform initiatives. While economic and demographic comparisons are not as strong with that of Australia, policy makers in the United States would be well served in looking at what lessons can be gained from these two models.

As a former International Research Manger for the Office of Fair Trading in the United Kingdom and a regulator of retirement products in Australia, I see it as very important for this Committee to comprehend the experiences of how Australia, Chile and the United Kingdom have fostered individual retirement accounts. Certainly it can be argued that the following international experiences, combined with the realities of an increasingly aging "baby boomer" population in the United States, will help solidify the need for individual retirement accounts.

AUSTRALIA

DEVELOPING AND NURTURING AN INDIVIDUAL RETIREMENT SYSTEM

For Australia, a country that at the beginning of the twentieth century had one of the highest standards of living in the world, the Old Age Pension, introduced in 1909, appeared to be both a stable and viable approach to meeting an individual's retirement needs in the future. Under the system a flat rate benefit is provided which equates to a maximum of 25 percent of male average weekly earnings. Before the 1980's a common mentality among retirees was that after paying taxes over their working lives, they were now entitled to an Old Age Pension from the Federal Government.

Yet as commodity prices slumped in the early 1980's and Australia encountered a deep recession, both politicians and bureaucrats alike realized that the current Old Age Pension could not be sustained with the rapid aging of the population. Simply put, Australia could no longer afford a "non-earmarked PAYG Old Age Pension" with its associated generous qualification requirements. The demographic concern toward Australia's aging population were echoed by the then head of the Association of Superannuation Funds of Australia, Susan Ryan who commented:

"For Australia the percentage of the population aged over 65 is expected to rise from 15 percent of the population, 2.9 million, to 23 percent by 2030, that is, 5 million people. The percentage aged over 85 is expected to more than double from around 2 percent to more than 5 percent amounting to 650,000 Australians over 85."[1]

Surprisingly for some in the United States, it was the Australian Labor Party, a social democratic political party who, with trade union (organized labor) support began to generate the momentum for change of Australia's retirement system. In the first instance the newly elected Federal Government began the process of ensuring the long-term viability of the Old Age Pension at its current level. Maximum payments per fortnight by the mid 1980's were now determined through the interaction of a comparatively stringent income and asset tests.

Clearly to engineer or make such a significant shift in the overall retirement structure of any country requires a strong political resolve and vision for the future of a nation's citizens. In Australia's case, more through coincidence and luck a popular Federal Government, through trade union support was able to convey to the nation the impending problems Australia would confront, if it did nothing about addressing its aging population. This theme of the realization and admittance of a future retirement hurdle was best summarized in the Better Incomes: Retirement into the Next Century statement which expressed a commitment to: "maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce."[2]

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[1] Susan Ryan, "Quality of Life as It Relates to Australia's Aging Population or Living to 100 in a Civilized Society," Association of Superannuation Funds of Australia, Speech, 1997.

[2] Senate Select Committee on Superannuation: "Safeguarding Super," June 1992, p.7, Canberra, Australia.

For trade unions, which had strongly supported the election of a Federal Labor government in 1983, increasing superannuation coverage was seen as a major priority. Before the introduction of mandated, second pillar, superannuation accounts, the extent of coverage of superannuation was limited to roughly 40 percent of the workforce. Typically employees who were covered by superannuation were employed in middle class, "white collar" jobs where usually women and people from minority groups were under-represented. Brandishing this as a major bargaining tool, the trade union movement set about convincing the Federal Government that the level of superannuation coverage needed to be extended, via compulsory contributions into individual accounts. Such a position adopted by the ACTU was in line partially with its counterparts in the United Kingdom and Denmark but yet diametrically opposes the position adopted by the AFL–CIO in the United States with regard to Social Security reform. By 1986 circumstances were ideal for the introduction of a widespread employment based retirement incomes policy. Continuing wages pressure and demands by the union movement on the government for a comprehensive superannuation policy to be initiated saw the introduction of award superannuation, set at 3 percent of an individual's yearly income. This amount was paid by the employer as part of centralized wage increase of 6 percent, with 3 percent of this amount being deferred into individual retirement accounts.

By the actions of the Conciliation and Arbitration Commission in requiring compulsory contributions of 3 percent to be made into individual superannuation accounts, award (employment conditions) superannuation was born. In the years that would proceed its actual implementation in 1987, individual superannuation account balances would gradually increase. The trade union movement and the Federal Government would work together in refining and improving the delivery and regulation of superannuation products to employees. Moreover trade unions would not simply just advocate a policy of increased superannuation coverage during the 1980's and early 1990's but would rather become vigorous in the running and management of specific superannuation funds. Such specific involvement in the day to day operations of superannuation funds was directed principally toward industry funds. These funds generally gravitate around an occupation or industry and are sponsored by employer and employee organizations. Fundamentally they were established to receive the 3 percent mandated award contribution. As at June 1996 there were 159 industry funds with 5.8 million accounts (35 percent of total accounts) and $17.6 billion in assets (6 percent of total assets).

Most experts and politicians agreed that 3 percent was not a sufficient level to generate adequate retirement income for employees once leaving the workforce. On this basis the Federal Government would again intervene in 1992 to reposition Australia's long term retirement income strategy.

STRUCTURE OF THE AUSTRALIAN SUPERANNUATION INDUSTRY—SECOND PILLAR

With a delay to the 1990–1991 wage case occurring, where the ACTU and the Government supported a further 3 percent round of award superannuation the then government saw its opportunity to act in a decisive manner toward retirement saving.

In August 1991 the then Treasurer foreshadowed the Government's intention of introducing a Superannuation Guarantee Levy which commenced on July 1 1992. In issuing a paper on the levy the Treasurer indicated that such a scheme would facilitate:

- a major extension of superannuation coverage to employees not currently covered by award superannuation;
- an efficient method of encouraging employers to comply with their obligation to provide superannuation to employees; and
- an orderly mechanism by which the level of employer superannuation support can be increased over time, consistent with retirement income policy objectives and the economy's capacity to pay.[3]

Additionally in a statement Security in Retirement, Planning for Tomorrow Today given on 30 June 1992, the then Treasurer, the Hon John Dawkins MP, reaffirmed the government's position and direction on the aging of Australia's population and the need for compulsory savings for retirement:

"Australia, unlike most other developed countries, meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments.

[3] Senate Select Committee on Superannuation: "Safeguarding Super," June 1992, p.13, Canberra, Australia.

"And, like most other people, Australians generally undervalue savings for their own future retirement. Private voluntary savings cannot be relied upon to provide an adequate retirement security for most Australians. This is so even with the very generous taxation concessions, which are available for private superannuation savings.

"* * * In the face of these factors, changes are required to the current reliance on the pay-as-you-go approach to funding widely available retirement incomes. This means that we need now to start saving more for our future retirement. It also means that saving for retirement will have to be compulsory. It means that these savings will increasingly have to be "preserved" for retirement purposes. Lastly, the rate of saving will have to ensure retirement incomes, which are higher than that provided today through the age pension system.

"There seems to be a general awareness in the community that something has to be done now to meet our future retirement needs."[4]

The Superannuation Guarantee Charge Act 1992 requires all employees to contribute to a complying superannuation fund at a level, which increased from 3 percent p.a. in 1992 to 9 percent p.a. It should be noted that some discrimination was made for small business in how the levy was introduced and increases, based on the size of the annual payroll. If the employer chooses not to pay the levy he or she will have a superannuation guarantee charge (SGC) imposed on their business operations by the Australian Taxation Office (ATO). By deciding to neglect their obligations under Act the employer will not receive favorable taxation treatment in regard to contributions made by them on their employees' behalf.

At the present time the levy is currently at 7 percent which will increase progressively by to 9 percent by 2002. The threshold for paying this levy was based initially on the individual earning a minimum of $450 per month. More recently employees may decide to opt out of the system and take the contribution in cash up to a level of $900 per month.

TABLE 1.—DETAILS OF THE PRESCRIBED SUPERANNUATION REQUIREMENTS LINKED WITH THE MANDATED SECOND PILLAR

	Employer's Prescribed Rate of Employee Support (Percentage)
July 1, 1997–June 30, 1998	6
July 1, 1998–June 30, 1999	7
July 1, 1999–June 30, 2000	7
July 1, 2000–June 30, 2001	8
July 1, 2001–June 30, 2002	8
July 1, 2002–03 and subsequent years	9

In March 1996, the then Labor Federal Government lost office and was replaced by a conservative, Liberal Coalition Government under Prime Minister John Howard. It had been the intention of the Australian Labor Party, with trade union blessing to further expand the compulsory nature of superannuation by gathering a 3 percent contribution from individual workers and providing an additional 3 percent to certain workers who met pre-defined income criteria. In total this would have meant that many workers' individual superannuation contribution accounts would have been receiving total contributions of 15 percent. Treasury estimates suggest that over a forty-year period these contributions would translate out to be approximately 60 percent of one's salary on retirement.

With regard to the taxation of superannuation, Australia has pursued a course which is quite unique and which on the whole I cannot agree with in terms of design and the overall rate of taxation applied. Based on Andrew Dilnot's model developed at the Institute of Fiscal Studies in London, Australia's taxation of superannuation can be described as TTT. Taxation of contributions at a rate of 15 percent, along with possible additional taxation of 15 percent for members' contributions who earn over $73,220. A further tax of 15 percent is levied on the investment income of superannuation fund and finally the benefits can be subjected to varying tax treatment of between 0–30 percent, depending on timing of the contributions.

The profile of the second pillar of Australia's retirement system depicts both a diversity and adequacy of return that reflects strong and vigorous competition among the financial services industry in Australia. Through a trustee structure, super-

[4] The Hon John Dawkins, MP, Treasurer: "Security in Retirement, Planning for Tomorrow Today, 30 June 1992, pp1–2, Canberra, Australia.

annuation funds are managed in the most efficient and effective manner for members. Life insurance companies and fund managers, like in the United States play an active role in the management and investment of superannuation fund assets. Additionally specialized administration companies have developed services that allow superannuation fund trustees to outsource much of their investment and administrative functions. This intense competition has led to in part returns being maximized and administrative fees being minimized.

Varying measurements exist for evaluating the success of how Australia has contained administrative costs, compared with other international models. In a recent paper presented at the National Bureau of Economic Research Conference, on the administrative costs of individual accounts, Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide and John B. Shoven, Charles R. Schwab, Professor of Economics, Stanford University made the following conclusions about Australia's cost structure:

"The Association of Superannuation Funds of Australia estimates that the average administration costs of their system equal A-$4.40 i.e., U.S.-$2.85-per member per week. In U.S. currency terms, administrative costs at this rate for a system that held average balances of $1,000 would be nearly 15 percent of assets per year. For a system that held average balances of $5,000, it would drop to 3 percent per year. For one that held average balances of $10,000, administrative costs would be 1.5 percent per year. By the time average account balances got to be $30,000, administrative costs would be under 0.5 percent per year. This pattern is important because it reflects the pattern of accumulating balances in a retirement system like Australia's as it is being phased in, as Australia's is now." [5]

Further evidence of the relatively low cost structure associated with superannuation accounts in Australia is highlighted in Table 4 prepared by the Financial Section of the Australian Bureau of Statistics, on behalf of Watson Wyatt Worldwide.

TABLE 2.—ADMINISTRATIVE COSTS AS A PERCENT OF ASSETS UNDER MANAGEMENT IN AUSTRALIAN INDIVIDUAL ACCOUNT SUPERANNUATION FUNDS DURING 1996 AND 1997 [6]

Number of members in the plan	1996 (percent)	1997 (percent)
1 to 99	0.689	0.619
100 to 499	0.849	0.673
500 to 2,499	0.803	0.797
2500 to 9,999	0.854	0.837
10,000 or more	0.922	0.846
Total	0.900	0.835

Source: Australian Bureau of Statistics, Belconnen, Australia Capital Territory, tabulations of a joint quarterly survey done by the Australian Bureau of Statistics and the Australian Prudential Regulation Authority (APRA).

A further effort to define the average administration costs for accumulation funds was published in the June Quarter 1998 of the APRA Bulletin. In analyzing superannuation fund administration, the regulatory authority indicated that average weekly administration charges were A-$1.35 per member or US-$0.86. I would like to mention briefly that investment decisions and strategies are developed solely between the investment managers and associated trustees of each superannuation fund. The Australian Government plays no role in shaping directly or indirectly the investment decisions of the individual superannuation fund but rather through regulation stresses the need for a sensible and sustainable investment strategy. Regulations refer to this approach as the prudent man test. Further, the December issue of the APRA Bulletin highlights that 39 percent and 16 percent of the total superannuation assets of A-$377 billion or US-$234.07 are invested in equities & units in trust and overseas assets. Clearly this level is deemed appropriate by government, trustees and superannuation fund members alike. A concise overview of the Australian superannuation industry as at December 1998, is provided in Table 3.

[5] Schieber SJ & Shoven JB: "Administering a Cost Effective National Program of Personal Security Accounts" (Draft), NBER, Cambridge MA, December 4, 1998, p.16.

[6] Ibid., p.17.

TABLE 3.—OVERVIEW OF THE AUSTRALIAN SUPERANNUATION INDUSTRY—DECEMBER 1998

Type of fund	Total assets (billions)	Number of funds (June 1998)	Members (thousands)
Corporate	69	4,259	1,456
Industry	26	108	5,847
Public Sector	84	62	2,878
Retail (including RSAs)—RSAs	102	363	8,957
Excluded	47	169,825	348
Annuities, life office reserves etc.	49		
Total Assets/Funds/Members	377	174,617	19,486

Source: APRA Bulletin, Australian Government Publishing Service, December 1998.

Unlike some other international retirement models, the third pillar of Australia's retirement income system is characterized by individual retirement accounts being generated on a voluntary basis through the private annuity, retail funds management and life insurance markets. Some taxation and concessional rebates offered for spouses and more generally savings incomes that are aimed at retirement provision have seen this sector grow in recent years. With regard to final benefits, Australia allows these to be taken in the form of a lump sum or annuity. Past experience has seen a lump sum favored by many retirees but with changes in recent tax laws, annuity and allocated pension vehicles are increasing in popularity.

I would like to now turn briefly to the mechanics associated with selling, distribution and withdrawal of benefits from the superannuation account. One of the reasons why Australia has been so successful in keeping administrative costs low and also avoiding the problems associated with mis-selling is through effective and cost efficient regulation. Strict rules govern how superannuation policies are sold and switched. Moreover consumers are required to receive minimum levels of information about the superannuation products at the time of sale and also on a regular basis. Clearly it is felt that, as this is the largest financial transaction that a consumer will enter into in their life, effective disclosure should be provided to encourage transparency in the transaction. Increasingly superannuation account holders are being provided with greater investment choices. Some retail funds for example offer between 5–7 investment choices and proposed legislation by the Federal Government will force employers to offer choice of funds. Consequently effective consumer protection strategies will provide an important deterrent for any forms of mis-selling from occurring.

As I have mentioned effective consumer protection strategies are crucial in offsetting the transitional risks linked with nurturing a more fully funded retirement system. In a recently published chapter of the book Consumer Protection of Financial Services, edited by Mr. Peter Cartwright and published by Kluwer Law International, Sue Jones and I argued that public education was crucial for the success of any associated Social Security reforms. Australia's experience of public education campaigns associated with Social Security reform took place in 1994 and was delivered between 1995–1996 by Federal Government agencies. To build a better understanding and stress the value of superannuation the Federal Government through the Australian Taxation Office, Department of Social Security and the Insurance & Superannuation Commission initiated a comprehensive publication campaign. This campaign harnessed both electronic and print media to convey several main themes including the future benefits of superannuation for the nation and the individual, information on how the new mandated system functioned and how a regulatory body was active in safeguarding superannuation assets. The estimated cost of this campaign was approximately A-$11 million in 1995 or the equivalent US-$159 million on a per capita basis. When devising the elaborate and integral public education campaign, the Federal Government was committed to directing part of the campaign toward women and ethnic minorities.

THE UNITED KINGDOM

It should be noted that the United Kingdom's (UK) pension system has been undergoing a period of reform for over twenty years. The UK pension system is structured effectively in two tiers. The first is a benefit provided by the state, which consists of the basic state pension and a significant level of means tested benefits. Since 1981, the level of the basic state pension has been formally indexed to the increase in prices. This form of state benefit is by far the major core of the British government's state provision responsibilities. Currently 10.6 million individuals receive the benefit at a cost of £32 billion (4.7 per cent of GDP). This compares favorably with other major OECD countries, as noted in Table 4.

TABLE 4.—PROJECTED FUTURE STATE SPENDING ON PENSIONS AS A PERCENTAGE OF GDP

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
United Kingdom	4.5	4.5	5.2	5.1	5.5	4.0	4.1
United States	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: OECD, cited in Johnson (1999).

To receive the benefit you must be aged over 65 for men and 60 for women, with the benefit calculated on a flat-rate, contributory basis. As of April 1999, the first pillar has been worth £66.75 a week for a single pensioner, which equates to 15 per cent of average earnings. An additional dependant addition of £39.95 a week is also provided where one partner does not meet the necessary contribution criteria. The second tier, compulsory for all employees above a certain floor, consists of the State Earnings-Related Pension Scheme and a largely vibrant and evolving private pension market.

In 1948 the Beveridge Report had developed a compulsory pension system which consisted only of the first tier. In effect this was the basic state pension and means tested National Assistance. Yet increasingly, pressure on the Government to provide a more substantial second tier approach for all workers developed, partly as a result of the strong growth in occupational schemes. Between 1953 and its peak in 1967, occupational pension coverage expanded from 28 to 53 percent of employees. This coverage in recent years has declined which partly can be attributed to an overall trend in changing employment patterns.

In 1975 the Social Security Act introduced the State Earnings Related Pensions Scheme (SERPS). Its design allowed occupational schemes to contract out of SERPS to avoid the scheme substituting for private sector provision. Effectively the design of the second tier pension was for those people not in occupational schemes.

During the initial period of this second tier pension scheme benefits, were comparatively generous with today's levels. SERPS guaranteed contributors to the scheme an additional pension of 25 percent of their earnings between lower and upper earnings limits. The scheme was compulsory. As indicated, employers and contributors could contract out of SERPS only into a salary-related occupational scheme if it offered benefits at least equal to those provided by SERPS.

Earnings in the best 20 years counted toward the pension at a rate of 1.25 percent of earnings between lower and upper limits. These limits were revalued in line with average earnings. Once payments commenced, the additional pension was uprated annually in line with consumer prices. The cost of uprating the basic pension (first tier) and SERPS was met by the National Insurance Fund.

Pensions under SERPS matured in 20 years and, as a result of the 20 best earning years formula, were especially advantageous to some groups. Employees earning more than the Lower Earnings Limit (LEL) for National Insurance Contributions (NICs) £57 per week for 1994–95 pay Class 1 NICs earn entitlement to SERPS as well as the basic pension unless they are contracted out. The Upper Earnings Limit (UEL) must by law lie between 6.5 and 7.5 times the basic state pension, and stood at £430 per week in 1994–95—around 120 percent of average male earnings.

In June 1985 the Conservative Government published a Green Paper, *Reform of Social Security*. This document highlighted the implications of the basic state pension and SERPS over the following 50 years. The concerns raised by this paper in regard these two forms of pensions provisions can be summarized by Budd and Campbell:

"The Green Paper pointed out that the increased cost of the basic pension would benefit all pensioners equally. However the case was different for recipients of SERPS. Its earnings- related nature meant that the newly-retired would benefit more than older pensioners. Also half the extra cost would result from payments to members of contracted-out schemes (to provide indexation top-up to the Guaranteed Minimum Pension). The cost of SERPS (in 1985 prices) was expected to be about

£24 billion in 2035, compared with a basic pension cost in 1985 of about £15 billion."[7]

A significant change to SERPS took place in the second half of the 1980's when the Social Security Act 1986 provided that from 1999 onwards, SERPS additions to the basic state pension would be calculated not on the basis of the best 20 years rule but instead on lifetime average earnings. Now SERPS would provide 20 percent of average earnings over the whole working life of the individual. The current cost of SERPS is only around two billion pounds per annum, due to relatively few retired people having significant entitlements. By 2030 in contrast, these entitlements will have grown to its maturity point.

In summary SERPS payments in the future will progressively diminish as a percentage of a person's final retirement income through changes in the 1980's which saw these payments linked to prices rather than earnings.

The UEL has fallen from 140 percent of average earnings to 120 percent and will continue to fall. With price indexation, and 2 percent real earnings growth per annum, the UEL will be less than 60 percent of average male earnings by 2030, implying a maximum SERPS pension of only 10 percent of average male earnings.

CONTRACTING OUT OF SERPS

As indicated previously, when SERPS was introduced members and employers of occupational schemes had the ability to generate a contracting-out rebate if the scheme agreed to provide a guaranteed minimum pension, related to individual average lifetime earnings. This rebate was initially set at 7 percent of earnings (between LEL and UEL for National Insurance contributions). The current rate, applying from 1993–94 onwards, is 4.8 percent.

In 1988, the contracting out option was extended to a further range of products, principally personal pension products. The reason for this decision is subject to some conjecture. Some elements say it had an ideological basis spawned by the then Prime Minister, Margaret Thatcher who felt that Government should not be involved in pensions provisions for the second tier. More likely was that advice provided by the Treasury and Government Actuary's Department indicated that through the affects of an aging population, the United Kingdom's economy would be crippled by overly generous welfare payments. The condition for leaving SERPS is not, that a guaranteed minimum pension should be paid, but that a guaranteed minimum contribution should be made. This minimum level is the contracted-out rebate. Levels of rebate offered to people newly contracted out into personal pensions (or group defined contribution schemes) was set above the rebate for those in occupational pensions. Initially, an extra 2 percent "incentive" rebate was offered with the aim of "kick-starting" the personal pensions sector. In 1993–94, this declined to an incentive rebate of 1 percent restricted to the over 30's. The rationale for this policy was that a large number have already taken out personal pensions, and so a kick-start is no longer required.

Through allowing people to contract out of their SERPS entitlements and transfer from occupational schemes personal pensions in 1988 received a significant boost in sales growth and long term product development. The popularity of these products was quickly established and thus by 1992 23 percent of male and 19 percent of female employees had contracted out and were in personal pensions.

Concern in Treasury and other areas of Government was that these new retirement vehicles were only being used to receive the rebate provided through transferring out of SERPS. In 1991, 24 percent of employees had contracted-out into personal pensions yet about three-fifths of these personal pensions had been established simply to receive the associated rebate and incentives provided by the Government. Such a situation led or induced the mis-selling of pensions, which has continued to erode a recovery in the public confidence, within the industry.

Overall personal pensions today are "manufactured" by a number of providers. These companies are mainly life insurance companies although building societies, unit trusts and other financial organizations are permitted to administer pensions (at least up to retirement). Restrictions on investments are relatively few and it is important to note that even supermarkets in the United Kingdom are offering such financial services products on an execution basis.

In general, the deposits from personal pension funds must be used to purchase annuity. Recent legislative amendments have increased the individual's freedom of choice between annuity suppliers. The Government has ensured that the same tax privileges extend to personal pensions, as which exist for occupational schemes.

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[7] Budd, A. & Campbell, N.: "The Roles of the Public and Private Sectors in the UK Pension System"—1996, HMSO London, United Kingdom, p.7.

A concise summary or assessment of personal pensions and the future role that they are likely to play in the British market is provided by Mr. C.D. Daykin, the United Kingdom's Government Actuary in his report to the European Commission.

" Personal pensions at the minimum level for contracting-out are unlikely to provide a very inadequate income in retirement. A major challenge for education (and marketing) is, therefore, to persuade people that they must make additional voluntary contributions and that the responsibility for ensuring an adequate retirement is theirs. The State will not provide more than the basic flat-rate pension. Of course, there will still be the possibility of means-tested income support, but the whole thrust of encouraging private provision for pensions is to lessen the dependence on State Benefits.

Views differ as to the likely success of these objectives. Trade unions and staff associations in general remain very suspicious of personal pensions, which they see as putting too much of the risk (particularly of investment performance relative to inflation) on the individual and too much money (commission, profit, etc.) into the hands of financial intermediaries, insurance companies and other financial institutions. The preferred option of organized labour is the final salary occupational pension scheme, if possible with full price indexation of pensions, both in payment and in deferment." [8]

CHILE

Chile was the first South American country to move toward adopting a mandatory, funded, privately managed defined contribution retirement system in 1981. In 1980, Chile passed Decree Law 3500 and 3501, which partially replaced the state-run-pay-as-you-go (PAYG), unfunded Social Security system. This system had functioned in Chile since 1924 and by the mid 1970's symptoms of its long term weakness, in providing benefits for recipients was increasingly becoming pronounced.

In effect the reforms meant that from May 1 1981, new workers were eliminated from having the option of becoming a member of the complex unfunded national defined benefit scheme, or in this paper referred to as the first pillar. Workers were also given the option up to 1985 of remaining with the old system or joining the new scheme.

By 1985 98 percent of workers had already joined the new scheme. Like any PAYG system, the first pillar failed to establish a strict linkage between the amount of benefits and contributions to the system. This flaw can often lead to irresponsibility and unaccountability, a trend complicated by the fact that the impact of inappropriate economic decisions will be passed on to other generations.

Chile quite obviously displayed these characteristics with a progressive decline in the numbers of workers matched against existing retirees:

"To illustrate the long-term effects of this trend, let us examine the active workers/retirees ratio of the old system. While the system's ratio was 8.6 in 1960, it declined sharply to 2.5 in 1979. At first glance, the drop could be attributable to the aging of the population. However, in 1960, the number of people over 60 years of age was 15.6 percent of those between the ages of 20 and 60; in 1980 the ratio was 16.7 percent, indicating that there were no significant changes in the average age of the population. This data shows that the old system was structured to provide benefits that surpassed its ability to pay." [9]

To assist workers in making contributions to the new defined contribution accounts, the dictatorship mandated that employers raise wages by 18 percent for existing workers and new labor force entrants. Clearly the advantage of introducing such reforms under a military dictatorship was highlighted in this aspect or transition of the Chilean Social Security system. Today the first pillar of the Chilean Social Security system can be described as a minimum benefit funded from consolidated revenues. Such a benefit guarantees retirement benefits worth the higher of 75 percent of poverty or 25 percent of a worker's average pay over the 10 years prior to retirement. This benefit will only be generated "if his or her defined contribution account is too small to generate equivalent income (i.e., to provide annual benefits greater than 75 percent of poverty or 25 percent of the worker's average pay), In such cases, the worker's defined contribution account is taxed 100 percent to help pay for the first-tier benefit. In other words, no Chilean receives payouts from both

[8] Daykin, C.D.: "Pension Provision in Britain—Report on Supplementary Pension Provision in the United Kingdom," 1994, HMSO, London, United Kingdom.

[9] Larrain, L.A.: "A Bold Step in Chile's Reforms: Privatization of the Pension System," Instituto Libertad y Desarrollo, Center for International Private Enterprise, 1993, Santiago, Chile, p.2.

of the system's tiers. If workers do not accumulate enough in their defined contribution accounts, they must forfeit their balance and receive the minimum benefit."[10]

As a basic safety net the State provides a minimum pension to employees only when the second pillar is unable to generate a sufficient pension, in retirement for the employee. A minimum will occur where their pension produces a monthly income which is less than Ch$51,014. Employees are required to have at least 20 years coverage to be eligible for the minimum pension. This minimum pension is not indexed, but adjusted by the government from time to time.

Under the system all benefits are provided through the AFP (pension fund administration companies). These are privately owned and managed companies who are regulated by the Superintendency of Pensions and are required to meet a variety of solvency and consumer protection issues. Although some pressure is mounting to lift the current retirement age in Chile, the existing level remains at 65 for men and 60 for women. Due to its defined contribution characteristics, the new system relies on the merits of the AFP generating a sufficient rate of return on its investments. The assessment of the likely benefits to be provided by the annuity that is purchased from a life insurance company, via accrued contributions was estimated by the Instituto Libertad y Desarrollo:

"Actuarial calculations indicated that retirement for men at age 65 and for women at age 60, with a pension of approximately 75 percent of their last active year's income, required a system that could deliver an average annual rate of return of 4 percent. This seemed perfectly compatible with the potential of Chile's economy."[11]

All covered or "dependent" workers must lodge 10 percent of their monthly earnings in a savings account with an approved, high regulated intermediary called the AFP. Each AFP manages a single fund, with the complete return on the fund being allocated to the individual accounts. An additional function of the AFP is also to provide survivors and disability insurance, according to rules prescribed by the government. Once the worker becomes eligible to receive pension benefits he or she has one of two options. They can choose a sequence of phased withdrawals provided by the AFP or purchase a real annuity. This latter option will require the affiliate to purchase the annuity from a life insurance company.

With Chile's long history of using indexed debt during periods of high inflation, this has allowed the regulator to quite easily restrict the annuity option to indexed annuities. Unlike other privatized models such as that in the United Kingdom and Australia, it is very rare to find any employer sponsored pension plans. With strong competition amongst multi-nationals to retain good quality staff, some are evaluating the possibilities for developing supplementary retirement benefits.

The major drawbacks associated with the Chilean model is the overall costs associated with administration, distribution and regulatory restrictions. In response to these concerns the regulators tightened the transfer rules, requiring account holders to produce ID card and the most recent statement of their account. The net effect has been that transfers have dropped dramatically. In five they have decreased from 220,000 a month to 22,000 with the sales force being consequently halved.

For example the administrators face extensive restrictions on investments. They must guarantee a return within a certain band of the average return of the industry, if needed, through their personal resources. The administrators can offer only one fund, the affiliate can invest with only one AFP. Existing banks, mutual funds, or insurance companies cannot manage mandated savings. Also transfer between different pension funds are restricted based on minimum stay periods and transfer fees. The fund administrators can charge fees as a percentage of salary (which is typical) and of the assets managed, as well as flat transaction fees for deposit, withdrawal, account statements.

In summary there is no doubt that the Chilean model has some ambiguous characteristics which are seen to detract from the overall system. The Chilean system's high administrative costs, relative to other government systems, pose a large problem for the Superintendency. The major historical statistics of the system are noted in Table 5.

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[10] EBRI Notes: "Chilean Social Security Reform as a Prototype for Other Nations," EBRI, Vol.18 Number 8, August 1997, Washington, United States, p.2.

[11] Larrain, L.A.: "A Bold Step in Chile's Reforms: Privatization of the Pension System," Instituto Libertad y Desarrollo, Center for International Private Enterprise, 1993, Santiago, Chile, p.6.

TABLE 5.—CHILEAN PENSION FUND SYSTEM—MAJOR HISTORICAL STATISTICS, 1981–1996

	Total Assets (MM US$)	Annual Return	Number of Affiliates	Number of Contributors
1981	291.82	12.7	1,400,000	NA
1982	919.50	26.5	1,440,000	1,060,000
1983	1670.24	22.7	1,620,000	1,230,000
1984	2177.54	2.9	1,930,353	1,360,000
1985	3,042.00	13.4	2,283,830	1,558,194
1986	3986.09	12.0	2,591,484	1,774,057
1987	4,883.07	6.4	2,890,680	2,023,739
1988	5954.12	4.8	3,183,002	2,167,568
1989	7,358.64	6.7	3,470,845	2,267,622
1990	9,758.30	17.7	3,739,542	2,642,757
1991	13,810.67	28.6	4,109,184	2,486,813
1992	15,399.57	4.0	4,434,795	2,695,580
1993	19,788.07	16.7	4,708,840	2,792,118
1994	23,925.72	17.8	5,014,444	2,879,637
1995	25,433.17	(2.5)	5,320,913	2,961,928
1996	27,523.17	3.5	5,571,482	3,121,139

Source: Superintendency of Private Pension Fund Administrators.

On the issue of market efficiency and competition a similar argument can be mounted that seemingly excessive or ineffective regulation puts an undue cost on AFPs and the market for private annuities. Associated regulations, which relate to the requirements for capital to enter the system, investment limitations, annual return requirements, and management fee limitations place an indirect cost on the associated affiliate and impact on associated competition among industry affiliates.

"The new system imposes minimum and maximum restrictions over the funds" rate of return on pension investments, such that no AFP is permitted to earn 2 percent more or less than the all AFP average. In addition, AFP commissions are subject to regulatory restrictions, including the requirement that commissions be levied only on new contributions (and not on assets or returns). New entrants to the AFP fund group are permitted, with minimum capital requirements for reserves set at approximately US$120,000—$480,000 (in 1991$). Finally, the Chilean government tightly limits AFP investments by specific asset class: the maximum allowable domestic (Chilean) equity holding was 30 percent of the fund's portfolio, while the foreign equities cap was 10 percent (later lifted to 20 percent), and government bonds can constitute no more than 45 percent of the AFP portfolio." [12]

CONCLUSIONS

For the United States, one particular international model cannot be used as a template for Social Security reform. Yet clearly the experiences of Australia, Chile and the United Kingdom lend weight to the argument that Social Security reform, through the use of individual retirement accounts, can be successful, based on returns generated on individual retirement accounts but moreover through the harnessing of the individual rather than the state, in providing for one's standard of living in retirement.

Today as in tomorrow individuals in Australia, Chile and the United Kingdom will be exposed less and less to the vagaries of political risk associated with their long term retirement "nest egg." Through providing the necessary infrastructure, all three countries are benefiting from empowering their citizens to be proactive with regard to their retirement savings and also minimizing the long-term liabilities linked with the retirement of the baby boomer generation in the next century.

Mr. HERGER [presiding]. Thank you very much. I want to thank each of our witnesses for, I believe, very interesting and positive testimony. At a time when we have the incredible challenges we hear facing us as a Congress for what we are going to do to help preserve and save Social Security, I think it is exciting, for me anyway, to hear some, I think, positive things that are going on.

Mr. Thompson, if I could ask you a question, if I could, State Street Global Advisors has designed an administrative model for

[12] Mitchell, O.S. & Barreto, F.A.: "After Chile, What? Second-Round Pension Reforms in Latin America," NBER, Cambridge, United States, p. 4–5.

worker accounts that uses current treasury and Social Security record systems. Bill Shipman of State Street testified to us that costs for a private account using this system could be as low as $5.00 a year. Are you familiar with these proposals? Do they alleviate your concerns?

Mr. THOMPSON. I am not familiar with that particular proposal. I am trying to lay concerns that you should worry about on the table. If you collect money through the Social Security-IRS mechanisms, you can keep the costs of collection down; you can do it without imposing a lot of burden on employers.

Those are the pluses. The minuses are there is tremendous time lags built in. You are not describing a system that looks like a 401(k) any longer. It is a system in which if I want my money going into the S&P 500, I may watch the S&P 500 move up by 30 percent while I am waiting for the money to actually get there because it is sitting in some account some place waiting to be processed.

There is the time lag issue, and then there is the question of once you get the money centrally processed who is going to actually manage it? Now, the Swedes are trying a middle ground here in which they process it centrally. They try to keep the administrative costs down through central processing, but they allow people—or they propose to allow people—to invest in any of a large number of mutual funds. So there is a lot of choice.

The jury is out as to whether they can make that work. The first challenge they will face is going to be to constrain the number of mutual funds that register to participate to a manageable number.

The other option is the thrift plan model, where you have a centralized system in which the government decides which five indexes are going to be used. We tell the worker this is all you can do, just one of those five, and you have got all of these concerns about do you trust the government. Do you trust them to vote the shares? Do you trust them not to manipulate the holdings? Do you trust them to put the money in the account on time?

I happen to trust the government but a lot of people don't, and those are the kinds of things that you have to struggle with.

Mr. HERGER. Well, I think the point that you brought up is one that we certainly need to consider this year, this 2-year, this lag time. Anyway, I felt it was very interesting.

On Mr. Shipman again, his testimony again during that period——

Ms. JAMES. If I could just comment about State Street.

Mr. THOMPSON. Let me just underscore the point Estelle made, and then I will give it to Estelle, and that is the thing that drives the costs in so many of these programs is the marketing costs. The first thing you need to do is to figure out how to organize the system to keep the marketing costs from getting out of hand.

Ms. JAMES. Right. I think in the State Street plan there would be a competitive bidding process so marketing costs would be kept down. And would be very little communication with workers.

One of the things that drives up costs in mutual funds is you can pick up the phone and there is an 800 number. And I think that is specifically excluded; that is, those costs are not included in the State Street cost estimate.

If you wanted a bare-bones plan, that is what you would have to do, you would have to eliminate a lot of the service that people are now accustomed to. But, in fact, that is what you should do for small plans. It wouldn't be economical otherwise.

I think in the State Street——

Mr. HERGER. How would we, for that year or 2-year period of time, until they would reinvest it then, according to what the desires of each individual is——

Ms. JAMES. Yes, you could—I think, after a certain period people would be permitted to take their money out into a broader set of options, but then they might incur additional costs which are not included.

Mr. HERGER. Right.

Ms. JAMES. I think that would be the plan, to have a kind of base level for everyone for small accounts and then the possibility of opting out at higher costs for other people.

Mr. HERGER. Anyone else care to comment on that?

Ms. JAMES. Could I make an additional point that the one or 2-year delay, we should remember, the one or 2-year delay in investing money only applies to the incremental money that has come in each year.

So suppose the system has been in effect for 5 or 10 years, you have a buildup of assets, and those are invested in individual accounts. Those are not sitting in some account somewhere. It is only the incremental amount that sits in a big pot, and that could be invested in a large aggregate fund either in treasuries or in some mixed portfolio, and everyone would then get a pro rata share of that. So I think the one or 2-year delay on the incremental amount is not as forbidding as it appears at first. There are ways of handling that problem.

Mr. HARRIS. Can I just make an additional comment, just quickly, on the experience of administrative costs and handling of accounts in Australia? I think it is important to note that Australia has 19.7 million individual accounts for a workforce of about 9 million workers, and it is important to note that people say that individual accounts can't operate but when I hear these statements I cast mine back to when we were regulators and developing the system. We envisaged that companies would become specific administrative costs or administrative companies. The Fidelities and the Vanguards in the United States operate in Australia very effectively and how they do it is they go into a company and say, we will run your accounts for you at a very low, low cost. Today, administrative costs companies are becoming very specialized with very, very, very good technologies, and administrative costs are going down, not up, in Australia. That is important to note through economies of scale.

Mr. HERGER. Thank you. I think it is also interesting to note when Social Security began in 1935, in the early thirties, the administrative cost was incredibly high then, I think even much higher percentage wise than what we are talking about here.

We have about 6 minutes on a vote.

Mrs. CLAYTON. I will retain my questions.

Chairman SMITH. If you don't mind, we will recess, run over and vote and come back and then Ms. Clayton will inquire.

Mrs. CLAYTON. What I will do is I will submit my questions. I won't be able to return.

Mr. HERGER. OK. Thank you. We will recess until the vote is over and come right back. Thank you.

[Recess.]

Chairman SMITH [presiding]. The subcommittee is reconvened. Let me ask the witnesses, on your time schedule, what we have before us is three more 5-minute votes, which takes on the average of 10 minutes a vote. Our original thought was we would adjourn at about 1:30. Dan, Estelle, Larry, what are your schedules?

Mr. CRIPPEN. Mr. Chairman, I have a 1:35 appointment based on the earlier schedule, which I could probably change if you would like me to.

Ms. JAMES. I could stay until I become very hungry. You have sandwiches? Then I can stay indefinitely.

Mr. THOMPSON. I can stay.

Chairman SMITH. And Dave?

Mr. HARRIS. Yes, certainly.

Chairman SMITH. Let me just throw out a couple of questions. And Kurt or somebody, if you would keep track of the television monitor and after they start the next 5-minute votes then give me a holler and I will run over there.

Steve Entin, who is chief economist at the Institute of Research on the Economics of Taxation testified last week that private accounts could boost growth by as much as 10 percent. What is your observation in other countries or what is your analysis, starting maybe with you, Dan, and going down?

Mr. CRIPPEN. Especially since Estelle has her mouth full. She probably knows more about the answer to your question than any of us here. Again, the report that I have referenced is only about five countries, and in the case of Chile, the United Kingdom, and Australia, it looks like national savings increased. As Estelle said earlier in her remarks, at least in the case of Chile, there is some preliminary evidence of increased economic growth. Nothing at the moment suggests 10 percent or numbers like that. We are talking about increases in net national savings of 1 percent and 2 percent, but such increases are significant, depending, of course, on how long the time frame is. Small amounts now add up to large amounts later.

Chairman SMITH. And maybe include in a different attitude about the same question the significance of this kind of forced or significantly encouraged private savings, the extent to which that may reduce other savings and investment.

Mr. CRIPPEN. I have to defer to my colleagues. Neither this report, nor anything else I know of, speaks to that question. I don't know whether it could induce additional savings. Again, the most important thing, I think, that we all need to keep our eye on—and most economists agree—is this: Does whatever we are trying to do, reform of any kind, increase net national savings either by the government or individuals and, in so doing, boost economic growth and give us a larger economy? That is the first and foremost question.

As far as other incentive effects are concerned, I don't know.

Chairman SMITH. I hear you saying it might reduce other savings but probably there is going to be a net increase in overall savings with some kind of a government pension plan?

Mr. CRIPPEN. It really depends, Mr. Chairman. If, for example, you decided to set up individual accounts but the Federal Government borrowed the money to do it, it would be a wash. You would have, in theory, no effect on national savings. However, if you take the surplus and set up private accounts, or if the government pays down debt, there could be a positive effect. You recall that last year, for the first time in a long time, we paid down some of the debt held by the public, which resulted in an increase in net national savings right there. So there are any number of ways to boost savings, but the increase has to be in the net, not just moving money around.

Chairman SMITH. Ms. James.

Ms. JAMES. Yes. As I said before, in Chile there seemed to be an increase in private saving. The mandatory saving apparently was not offset by a decrease in voluntary saving. Of course, that doesn't mean that that would be the outcome in the United States or some other country.

For example, if the credibility of your retirement benefits became greater, if people really expected the mandatory plan to bring about greater retirement benefits because of the higher rate of return, this might induce them to cut back on private voluntary saving. On the other hand, in the U.S. people do so little private voluntary saving that I don't think this is a big concern.

The question of how the transition is financed is a key question, as Dan said, because if you—because ultimately in order to increase savings you have to cut someone's consumption. If we are determined to keep Social Security benefits and other government spending where they are and if we are going to have a carve-out and not an add-on, then it is not clear where the extra saving comes from.

The extra savings could come from having an additional tax to fund the individual accounts or it could come from cutting back on other government expenditures to finance the transition, or it could come from saving the surplus if you think that otherwise the government would spend the surplus. Those are all ways that you could have additional saving relative to what you would have without the individual accounts. But ultimately it has to mean less public or private consumption if you want to have more saving.

Chairman SMITH. I am going to take the liberty of being somewhat exceptional here. Mr. Thompson and Mr. Harris, I am going to ask also for your responses which will be on the record, and I hope all the other committee members will review, and so if you would also give your response to this question without anybody setting up here except staff, and then we will be in recess for approximately another 10 minutes to finish these last two votes.

So with that, please excuse the impropriety.

Mr. THOMPSON. OK. Well, I would make a couple of points. First the evidence about the impact on the economy is strongest with respect to the impact on the growth of financial markets, and less strong with respect to whether savings would be increased. Improving financial markets is a very important goal the transition economies and probably in many Latin American economies. It is not a very important goal in the United States. We don't need to have better financial markets to improve our economy.

The evidence is pretty good that savings have increased in Australia. I think the Chilean evidence is somewhat more mixed about whether the savings actually went up as a result of their pension reform.

In the U.S., as Estelle says, it is all a question of what's the package and what's the counterfactual. If the package is that the Federal budget surplus will be distributed to individual accounts and the counterfactual is that it will be used to cut taxes, there is a good chance of producing more savings. Most of the increase in savings is going to come from people who are asset constrained—lower-income people who don't have very many assets. The money will go into their individual account and they don't have any way to offset it, so they will end up having more savings. The higher income people can adjust their portfolios rather easily and are probably not going to increase their savings as much. So whether you have increased savings or not is going to be a question of what's the counterfactual.

If the alternative is a tax cut or something else that wouldn't increase savings, you will get some increased savings. You will get it mostly among lower wage workers. The amount that you are talking about probably isn't very great if you are talking about accounts that start with 2 percent of contributions and it is only the lower half of the income distribution that is likely not to offset it by adjusting their other portfolios.

Mr. HARRIS. I think it is important to consider with regard to the experience in Australia that back in 1983 the assets in superannuation retirement accounts were 32 billion in Australian dollars in 1993. Today, they stand, as of the of December, at $377 billion, certainly a significant shift. The reality is that individuals are saving more for their retirement.

I think the challenge, though, that has been encountered in Australia has been the shift of savings from bank accounts to more long-term retirement vehicles, and certainly that shift of flow of funds has caused some concern certainly in the banking sector in terms of how they can adjust their practices, and more importantly banking these days has involved a complete suite of financial services.

What is important also to note in the Australian experience was the strong and aggressive development of the capital markets back in 1983, and certainly in the mid-eighties the capital markets within Australia was relatively small and limited. Today, it is very aggressive with major U.S. players, Merrill Lynch and other providers, Vanguard and Fidelity, entering the market and being very aggressive in providing services.

I think the challenge obviously with regard to savings is also on the national level Australia has, like the United States, been a nation traditionally that doesn't save a heck of a lot of money, and more importantly what you are seeing is that the government is relying increasingly on the superannuation saving to do funding of infrastructure and privatization programs.

Thank you.

Ms. JAMES. I could just add that when I look at the various proposals that are floating around in the U.S., and many of them involve the use of the surplus to finance the transition to individual accounts, I think what is motivating many of the supporters of those plans is the presumption that if you didn't put that surplus into individual accounts the money would either be used to cut taxes or to increase government expenditures. Relative to those two alternatives—that is if the surplus were used either to cut taxes or increase government expenditures on the one hand or if they were saved in individual accounts on the other hand—then you would get more saving if the money went into individual accounts.

I think that is the reasoning that lies behind some of the proposals that have been made in the U.S.

Chairman SMITH. The Task Force will reconvene. Please accept my apologies. We are unusually loaded with votes for a Tuesday afternoon, and Mr. Dan Crippen has agreed to respond to written questions.

It seems to me that, Mr. Harris, at the end of your written statement you raise the issue of reduced political risk of private accounts. Do you feel that this reduced political risk has compensated for the assumption of market risk in the countries you studied?

Mr. HARRIS. Yeah. I would like to respond to that and tell you, yes, I think clearly the concern, obviously, that has taken place, for example, in Germany, France is that in the long term that people are making retirement provisions at the moment under a system where, say, they are going to be retiring on 70 percent of their final salaries.

It is likely that the government will have to do two things: one is to cut benefits by a number or increase taxes by a certain percentage, and it is the same dilemma that politicians have confronted in this country, whether it be cutting benefits by 25 percent or increasing taxes by 30 percent.

I think the challenge that Australia faced politicians, in talking to politicians while a regulator, was that they felt that the political risk was largely being devolved out, that is, that under the current system, while politicians can alter the regulations and the overall structure of the system slightly, generally the market risk would now, if you like, be more closer aligned with the individual.

Now, what that has meant in Australia is the real rates that return on average in 1997 was something like over 12 percent, about 12.2 percent; and market failure with regard to individual retirement accounts has largely been minimized in Australia through effective regulation.

So, in summary, I think what is, I think, relieving for an Australian is to know that their retirement responsibility is largely engaged with a financial firm, whether it be a life insurance company or a mutual provider, rather than being tied to the whims of political change possibly, as being confronted by a Frenchman or somebody living in Germany, for example.

Chairman SMITH. In terms of other countries using their retirement pension program safety net, if you will, as a welfare program, give me your analysis of what other countries are doing in this regard.

Mr. HARRIS. Sure. I think with Australia what is important is to make a distinction with the U.S. program—is that the old-age pension or the first pillar is essentially a welfare payment, that is, it is a flat rate 25 percent of that whole total average weekly earnings, which is means-tested through income and assets.

What is important, I think, is the long-term projected future state pending for the pensions programs in Australia, for example, is a percentage of GDP. Currently it is about 2.6 percent of GDP. By 2040, 2050 it will be about 4.3 to 4.5.

Now, that compares to, say, the United States at about 7.1, 7 percent; but if you look at the programs, compare it, say, to Germany or France who don't look at their first pillar as welfare, it is mainly as income or placed under a pay-as-you-go system, the numbers get very, very frightening.

For Germany, for example, by 2050 the projections are by the OECD that it will be 17.5 percent of their GDP will be consumed by future state spending on pensions.

Chairman SMITH. Excuse me. That represents 45, 50 percent of wages?

Mr. HARRIS. Basically it is 17.5 percent of their GDP as a percentage will be consumed in state spending on their pensions, on their first pillar.

Chairman SMITH. And do you have a feel how that relates to wages, anybody?

Mr. HARRIS. Obviously, what is happening——

Chairman SMITH. There is a percentage of wages?

Mr. HARRIS. In Germany and France, for example, the social costs of, say, hiring a worker in Germany, for example, the social contribution costs are about 22 percent. So if you hire a worker, say 100,000 U.S., you are going to have to make contributions of roughly 42,000 into the social insurance programs.

Chairman SMITH. Let me get Ms. James's and Mr. Thompson's reaction to using general funds to progress more if it is to the extent that it becomes more of a welfare program.

Ms. JAMES. Well, I think that you have to make a basic distinction, basic choice, about whether you want to have one contribution that does both the redistribution and the savings part of old-age security or whether you want to split those two; and many of the reforming countries have split them and they have a first pillar that is largely redistributive and a second pillar that handles people's individual accounts.

Whether you are looking at the Latin America countries or most of the OECD countries, they have this split; and often some of that first pillar is financed out of general revenues.

In the case of Chile, the first pillar is just a minimum pension guarantee that goes to people who haven't accumulated enough in their second pillar.

In Argentina, everyone gets a flat benefit. Everyone who has worked for 30 years gets a flat benefit that is about 25 percent of the average wage.

Now, in some of these countries you do use general revenue finance. General revenue finance is actually more redistributive than getting the money from a contribution because it has a much broader tax base. It is more distributive and would generally be considered less distortionary because you don't have a high tax levied against payroll. Instead, you have a much lower tax rate levied against all income, and this is a very broad tax base.

This would require a much larger revamping of the U.S. system than is being considered in most of the proposals here, but you could make a good economic argument for that.

Chairman SMITH. Mr. Thompson.

Mr. THOMPSON. Economists have always liked the approach of separating the insurance aspect and the redistribution aspect, but the rest of the population has never been quite so interested in that approach.

This is a philosophical issue. The Australians have had a long tradition of running a means-tested program in which many people participate. They accept that a majority of the aged population will get benefits, and 60 percent of the population participates, and nobody thinks that there is anything particularly wrong with that.

In the United States, means-testing has a different feel to it. Traditionally, it was deemed that something was wrong with you if you have to turn to a means-tested program; there was a fair amount of looking down your nose at the situation.

We have responded to that philosophical position by basically trying to assure that if somebody worked all their life, when they reach retirement they would get a decent income—a poverty line income or an income a little bit above the poverty line—without having to turn to a means-tested program.

Currently in the U.S., if you work for 30 years at the average wage, you will get a Social Security benefit that keeps you above the poverty line, although not a whole lot of above it. You and your widow won't have to turn to SSI. One could make the system somewhat more efficient by reducing the Social Security benefit and having SSI come in as an offset to pick up more of the income support load.

The most important single thing to worry about, though, is whether that is the way you want to treat old people who have worked all their lives.

Ms. JAMES. When we think about the Australian means test, it is important to realize it is not a means test for a small proportion of the population. It is a benefit that the majority of people qualify for. Only the top one-third of people do not get that benefit.

So it really excludes the upper third, rather than simply including a small group; and furthermore, the house that you own is not counted as part of that means-and-asset test. So it is really geared to benefit the large middle class, and that is part of the reason why it gets broad support in Australia.

Chairman SMITH. So, Mr. Harris or Ms. James, what is the percentage of retirees that are going to retire next year that would be eligible for the fixed-benefit Australian program?

Ms. JAMES. Oh, about two-thirds of them.

Chairman SMITH. Pardon?

Ms. JAMES. About two-thirds.

Mr. HARRIS. I think it is slightly higher at the moment. It is about 71 percent. I think what is important to note is long-term aspects of this. As people's superannuation or retirement accounts are increasing, their eligibility for this old-age benefit is declining.

So, in other words, the long-term projections by the commonwealth treasury are that the actual cost of the public spending associated with the old-age program will be largely contained. It will increase slightly, but if they hadn't brought in the mandated superannuation program, bumping up people's assets, it would have been pretty much a runaway expense on the budgetary process.

Ms. JAMES. That is probably one of the reasons why they added this mandatory retirement savings account, in order to contain the future government expenditures on the means-and-asset tested benefits.

Chairman SMITH. I have been suggesting, and I would ask you to evaluate the truth of this, is that the quicker that the United States deals with reforms of our Social Security program so that we don't end up being in the kind of situation that we now see Japan or a lot of Europe, the more economic competitive advantage we will have over these other countries. Can you react to that statement?

Mr. HARRIS. I would maybe like to jump in and say that certainly I think that is a very valid point. The analysis Watson Wyatt Worldwide are doing currently in an international study with one of my colleagues, Dr. Syl Schieber, on this issue, looking at 24 countries, we are looking in the future where the large global industry companies, for example, the GEs, the IBMs will have to make an effective decision where they allocate their capital, and the question will be asked where are the flexibility and the state Social Security programs.

I think, clearly, the international competitiveness of some countries, like Italy, where by, say, 2040, 2050, the figures I have that they are going to be dedicating 21 percent of their GDP toward state pension payments, the question has to be asked whether that will be sustainable. And that compares to, say, Australia at the same time of 4.3 percent and the United States at 7.1 percent. Japan, of course, is 14.9 percent.

So, clearly, the question would have to be asked are global industry participants going to be seeking nations or countries that are globally competitive with regard to employee remuneration and benefit generation.

Ms. JAMES. Yes. If we move toward funding sooner that means that contribution rates won't have to rise as far or as fast as they would have to rise otherwise.

Now, if contribution rates go up, one of two things can happen: either workers' take-home pay will go down, that is, workers will absorb that whole increase of the contribution rate by having lower wages—that won't make the workers of the future very happy—or if wages don't immediately bear that full burden, employers will; and that means employers' labor costs will go up, and they will be less interested in employing American workers.

Just as a current example, when I was in Berlin a couple of years ago and Berlin was under reconstruction, there was a lot of employment there, but the jobs were not being done by Berliners. Instead, Berliners were unemployed.

In East Berlin there was a very high unemployment rate yet workers were being brought in from Portugal, Spain, and Poland because of the high social insurance costs that could be avoided by importing workers. That gives you a very dramatic example of how employers do respond to higher labor costs.

Mr. THOMPSON. Let me just say that it depends a whole lot on how you resolve this issue. There are some proposals that are floating around which would make matters worse, I think.

Proposals which create huge government guarantees, I think, should be looked at very carefully. They're mortgaging the future by betting that the stock market will continue to rise at some fairly rapid rate. They're mortgaging the future treasury by saying that no matter if the market goes sour, the government will pay you off anyway. I don't think that is going to help anybody's international competitiveness. That is a foolish idea.

So settling this in a way that everyone believes is a fair way, a way that preserves some work incentives and a way that probably deals forthrightly with the fact that if people live longer, they are either going to have to work longer or else they are going to have to put more away each year they do work and doesn't try to sweep that away under the rug through some shell game with the stock market—settling it in a responsible way is going to help. But papering over the problem by moving a lot of money around and hoping nobody noticed that its all a shell game, and creating a guarantee out there that in 2020 the Secretary of the Treasury may have to find billions of dollars to write checks that nobody bothered to cover, that isn't going to help.

Chairman SMITH. Couple of illusions that disturb me greatly. One is that as the economy expands, somehow that is going to solve Social Security in this country. To the extent that we have benefits based on wage inflation rather than traditional inflation, that is just not true in the long run.

Ms. JAMES. Growth is good for workers, and it is good for pensioners; but it is not going to solve the Social Security problem.

Chairman SMITH. I am frustrated with my dealings with some of the strong senior organizations such as AARP that are just so convinced that they don't want to do anything to the pay-as-you-go fixed-benefit program because they like the illusion of security. And have any of you got any suggestions how to get a message out to seniors that that security is illusionary?

Ms. JAMES. I don't know. There is actually an interesting paper by someone named John McHale at Harvard University, where he has calculated the changes in Social Security wealth in a number of different European countries just due to changes in the pension formula, which gets back to the political risk issue that you raised before. And he shows that there have been substantial changes in people's Social Security wealth simply by, a vote of the legislature.

Mr. THOMPSON. I say, this part of the conversation depresses me. A few years ago there was a realization that we are going to live longer and we are going to have to make painful choices about how to adjust to longer lifespans. Unfortunately, in the last couple of years, the voices that are selling something for nothing seem to have risen to be louder than anybody else's. As long as others claim to have a plan that doesn't cost anything and guarantees current law benefits off into the future, why should the AARP have a debate and discussion about raising the retirement age or cutting benefits or raising contribution rates. That is the unfortunate part of this political debate right now.

Chairman SMITH. Are there any other countries in the world that are going to a pay-as-you-go program?

Mr. THOMPSON. What do you mean "going" to one?

Chairman SMITH. That are changing from some kind of a fixed contribution to go to a guaranteed benefit? To my knowledge——

Mr. THOMPSON. No one that I know of went to a pay-as-you-go as a conscious decision. Usually, they start off with partial funding; and it sort of dissipates for one reason or another.

Countries that go to individual accounts soon start to build in guarantees.

Everybody starts building in guarantees. Now, if you have a system in which there is a fairly reasonable base, that is a defined-benefit base, then the temptation to build guarantees is less. But, the more you rely on some kind of a defined-contribution individual accounts for the retirement income, the more the political pressure is to have the government guarantee some minimum income or minimum return or something like that. Guarantees like this are another thing I would urge you to try to avoid getting involved in.

Chairman SMITH. Let me ask each one of you to finish up with a closing statement of a couple minutes, and then I think we will adjourn. Mr. Harris, starting with you.

Mr. HARRIS. I think, just to add some closing comments, I think it is important, obviously, to consider with regard to Social Security the examples or the experiences that other countries are facing today.

The United States' trading partners, whether it be Italy, Germany and France, are certainly in the grips of an enormous problem, probably more of a dilemma than the United States finds itself. The challenge that the United States does have, though, or the advantage, is it is discussing or debating these issues.

In France, Germany and in countries, say for example, Sweden, there is a, if you like, a strong inertia, can we take on, can we reform this system, this is our right.

I think to add to your comment about the AARP, one thing that was very important in Australia was the generational impact. The future generations effectively, if you don't reform a pay-as-you-go system, are going to somebody has to eventually pay; and the politicians that I would talk to in Australia, and certainly in the United Kingdom, they feel benefit in that they are seeing the system developing such that the individual is playing a greater role in shaping their retirement futures rather than state.

And I think that is the theme I would like to leave you with is that the politician is there to build the infrastructure, the system, whereby the individual can be empowered to greatly shape their future destiny in terms of retirement, but at the same time don't avoid the requirement to provide a basic safety net or basic requirement for people with retirement needs in the future.

Chairman SMITH. Mr. Thompson, do you have a comment?

Mr. THOMPSON. Just to reiterate that these are very complicated systems that get built, and people can design all kinds of theoretical structures. You need to be very careful in that in analyzing those structures, because if you buy into one of these, you are putting your name on how it is going to operate.

And the experience around the world is that there are very serious tradeoffs, and there are compromises that will have to be made. The political process is one which makes the compromises but tends to oversell the result. And now you are over selling in a program which is a very popular program that lots of people are going to be watching, and I don't think you want to be in a position of telling people you have designed a system which, when they look at it, they say we don't like this system.

So be careful and look closely at the details of what you are designing and how it is going to work.

Chairman SMITH. Ms. James.

Ms. JAMES. OK. Four points: first of all, we do see that countries around the world are reforming and it is still spreading from Latin America, the OECD countries, now Eastern Europe is reforming. So, you know, there is a movement toward prefunding, toward defined-contribution plans as part of the system; and I think we can learn both from the successes and the problems of those systems. So that is point number one.

Point number two is I think we have an increasing consensus among economists and among policy makers that some degree of prefunding is desirable in a Social Security system. When we first published averting the old-age crisis in 1994, that was a kind of controversial idea; and I would say it is not very controversial right now.

I think that the whole world of academics and policy makers has moved to recognize that prefunding is important for the economy as a whole and for the old-age systems as populations age. So it is important because it is a mechanism of increasing national savings and keeping contribution rates relatively level and sensitive to the aging of the population. So that's point number two.

Point number three is once you have funds, you have to decide how you are going to invest those funds, who is going to have control over those funds. And the advantage of putting the funds into individual accounts is that it insulates you somewhat from political manipulation of the funds.

Of course, this is very controversial here in the U.S. My own personal, purely personal, opinion is that if you have centrally managed funds, it is impossible to totally insulate it from political manipulation; but that is—people will differ on that judgment, and that is a very key issue that you have to think about.

Now, point number four is if you decide to have individual accounts, in order to avoid that political manipulation, then you have to think very carefully about how to set up the accounts so as to keep administrative costs low while still preserving some degree of choice and incentives for good performance. That is your job.

Chairman SMITH. Thank you very much, and for your information. As chairman of this Task Force, I send a synopsis of each of your comments to the 435 Members of the House. So, again, thank you very much for giving some of your time. Again, my apologies for the in and outs of our votes this morning, but thank you all very much.

CONGRESSIONAL BUDGET OFFICE LETTER DATED JUNE 24, 1999, SUBMITTED FOR THE RECORD

CONGRESSIONAL BUDGET OFFICE,
U.S. CONGRESS,
June 24, 1999.

Hon. NICK SMITH,
Chairman, Task Force on Social Security, Committee on the Budget, U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Center on Budget and Policy Priorities (CBPP) recently prepared a critique of my testimony on Social Security reform in other countries, which was presented to the House Ways and Means Committee on February 11, 1999. CBPP distributed its paper at the hearing before the House Budget Committee's Task Force on Social Security on May 25, 1999, at which I testified. Because I did not receive the paper in time to comment on it then, I request that this response be included in the record.

The Center's report concludes that the experience of the countries, examined in the Congressional Budget Office's (CBO's) paper Social Security Privatization: Experiences Abroad (January 1999), has little relevance to the United States—yet ironically, it cites the virtually identical experience of this nation. The CBPP report also makes a case for examining more mature, industrialized nations but provides no such examples. The paper claims as well to offer proof that Social Security surpluses have heretofore been saved, presenting a hypothesis that it does not prove—in fact, the evidence suggests the opposite.

The retirement of the baby-boom generation, which dramatically lowers the ratio of workers to retirees, will challenge us to improve the solvency of our retirement programs. Policymakers have proposed a variety of possible reforms ranging from funding our traditional Social Security program to relying on private accounts. There is tremendous uncertainty about how Social Security reform proposals would work in practice and how they would affect the economy—two central questions in evaluating any such plan.

In attempting to answer those questions, it is natural to ask what can be learned from other countries and from our own history. Unfortunately, the lessons are not always clear. Not only is the past hard to interpret but each country's experience has unique features. As I observed in my testimony, "The economies and pension systems of those countries [specifically, Chile, the United Kingdom, Australia, Argentina, and Mexico] differ considerably from those of the United States' and "comparisons should therefore be made cautiously."

My testimony, which focused on experiences abroad, included a simple observation drawn from CBO's January 1999 analysis: none of the five countries CBO studied successfully maintained permanent prefunding of their government-run, defined benefit pension systems, although four of them expressly intended to do so. The United States' experience with prefunding, which was outside the scope of my testimony, is consistent with that finding. As the CBPP paper noted, the Social Security program in this country was originally set up as a funded system, but the goal of building large reserves was soon abandoned in favor of pay-as-you-go financing.

CBPP argues that it is understandable that a new retirement system would have trouble building up balances in the early years. Although that observation seems empirically correct, it misses two crucial points that the experience of the other nations indicated above. First, those countries explicitly intended to create prefunded trust funds—and actually began the process. Nevertheless, they ultimately failed in their objective.[1] Second, after they established their retirement systems, the countries did not later convert them to prefunded systems. In general, the demographics (that is, the ratio of workers to retirees) were far more favorable to prefunding in earlier decades than they are today; in the future, the demographics will continue to worsen with the retirement of the baby boomers.

One interpretation of those facts is that it could be difficult to prefund the U.S. Social Security program within its current framework. Despite projections that current-law Social Security revenues will exceed benefits until 2014, some observers believe that pressures will inexorably mount to use the resulting Social Security surpluses for either tax cuts or additional spending. That view has some currency at many points along the political spectrum, and the Administration seems to share those concerns. Indeed, the President recommended as part of his framework for reform that the proposed transfers from the general fund to the Social Security trust

[1] The history of the United Kingdom is actually more robust than the CBPP paper suggests. The U.K. started with a pay-as-you-go system, then tried to convert to partial funding—only to return to the pay-as-you go model.

funds be recorded as outlays. That proposed change in budgetary accounting would redefine—and reduce—the size of the measured unified budget. In the Administration's view, the redefinition would limit temptations to spend the surplus. Congressional interest in establishing a Social Security "lockbox" arises from precisely the same concerns about the likely failure to save the Social Security surpluses.

In that context, the CBPP critique raises an interesting issue that I did not discuss in my testimony: how to interpret what happened after the 1983 amendments to the Social Security Act. A review of recent fiscal history suggests that the surpluses that accumulated in the Social Security trust funds were spent on other items in the budget. (Although that is literally true, the result could be indicative of higher spending or lower taxes than would otherwise have been the case.)

Indeed, after adjusting for the effects of the business cycle, the unified deficit in the next 12 years remained higher than it was in 1983. According to CBPP's hypothesis, by realizing the trust fund surpluses, the government should have reduced, rather than increased, the adjusted unified budget deficit. Yet as the Social Security surpluses grew, even without adjustment the unified deficit fluctuated with no apparent relation to the trust funds. Since 1983, the Social Security surpluses have been spent on other programs, and the government accumulated debt, not assets. And at least through the last fiscal year, at the same time that the Federal Government has been collecting historically high revenues, an on-budget deficit remains—because we are still using some of the Social Security surplus to finance the rest of the budget.

Although alternative explanations are possible, the coincidence of U.S. history and that of other countries raises legitimate concerns about the potential difficulties of prefunding Social Security. CBO's January 1999 paper was limited to five countries that have "privatized their retirement systems." Although there may be examples of "western, industrialized countries with mature retirement systems" (other than the United States and the United Kingdom, whose efforts failed) that have successfully prefunded their retirement systems, CBPP does not provide them in its critique.

I hope this letter clarifies the issues noted above. Feel free to call me if you have any questions.

Sincerely,

DAN L. CRIPPEN,
Director.

[Whereupon, at 2 p.m., the Task Force was adjourned.]

The Social Security Trust Fund: Myth and Reality

TUESDAY, JUNE 8, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12 noon in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Chairman SMITH. The vote is over. The Budget Committee Task Force on Social Security will come to order.

I will give a statement, and then, Lynn, if you would like to make some comments, and then we will proceed with our witnesses today.

I ran to make the vote. Excuse me a minute.

The problems facing Social Security as our society ages are, I think, much better known today certainly than they were 2 or 4 years ago. We on this Task Force have been studying the pressures on its pay-as-you-go financing system and various options for modifying and strengthening it. Today, the Task Force directs its attention to the Social Security Trust Fund.

The Social Security Trust Fund has existed as an accounting entity since 1937. The government credits it when payroll taxes exceed Social Security payments and debits it or comes up with other creative financing when benefits exceed taxes. It was created to keep track of all of the funds that the government collected for Social Security benefits.

The 1983 reforms, however, changed the role of the Trust Fund. At that time Social Security stood on the brink of default. In response, Congress passed the recommendations of the so-called Greenspan Commission, which included a payroll tax increase, the taxation of some benefits, an increase in the retirement age as well as some other changes. The higher payroll tax caused money to come in very quickly to Social Security and ultimately dramatically expanded the so-called Trust Fund to the point that the Trust Fund now stands at more than $740 billion for Old Age Survivors and $92 billion more for disability insurance. We must find an effective way to hold and pay back this enormous sum of money for the retirement of the baby boom and future generations.

It is in this role that the Trust Fund could fail. It cannot work because it holds no independent assets. Though the Trust Fund is backed by government securities, these have a different meaning than they would in a private account for you or me. If I hold a government bond, I have an asset that the government will give me money for or that I can sell at any time. If the government holds a bond on itself, however, its obligation to give itself money is somewhat meaningless. The government cannot make these bonds good, as needed in 2014, except by borrowing, reducing other expenditures or increasing taxes.

Clearly the Trust Fund means less than the public imagines. But what does it mean? Does it exist? Can Americans depend on it? Some, including the AARP, have said that the Social Security is OK until 2034. But what will the government have to do to honor the Trust Fund beginning in 2014?

I think as a heads up, we should look at what happened to the Highway Trust Fund when the highway bill was redrafted, and approximately $22 billion of the Highway Trust Fund money was written off.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF THE HONORABLE NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

The problems facing Social Security as our society ages are well known. We on this Task Force have been studying the pressures on its pay-as-you-go financing system and various options for modifying and strengthening it. Today, the Task Force directs its attention to the Social Security Trust Fund.

The Social Security Trust Fund has existed as an accounting entity since 1937. The government credits it when payroll taxes exceed Social Security payments, and debits it when benefits exceed taxes. It was created to keep track of all the funds that the government collected for Social Security benefits.

The 1983 reforms, however, changed the role of the Trust Fund. At that time, Social Security stood on the brink of default. In response, Congress passed the recommendations of the Greenspan Commission which included a payroll tax increase, the taxation of some benefits, and an increase in the retirement age. The higher payroll tax caused money to come rushing into the Social Security Trust Fund, to the point that the Trust Fund now stands at more than $740 billion for Old Age Survivors and $90 billion more for Disability Insurance. We must find an effective way to hold and pay back this enormous sum of money for the retirement of the baby boom and future generations.

It is in this role as a savings account that the Trust Fund could fail. It cannot work because it holds no independent assets. Though the Trust Fund is backed by government securities, these have a different meaning than they would for you or me. If I hold a government bond, I have an asset that the government will give me money for or that I can sell at any time. If the government holds a bond, however, its obligation to give itself money is meaningless. The government cannot make these bonds good, as needed in 2014, except by borrowing, reducing other expenditures or taxing citizens.

Clearly, the Trust Fund means less than the public imagines. But what does it mean? Does it exist? Can Americans depend on it? Some, including the AARP, have said that Social Security is OK until 2034. But what will the government have to do to honor the Trust Fund beginning in 2014?

These are our questions for today. I look forward to our witnesses' presentations.

Chairman SMITH. Anyway, our questions today relate to the Trust Fund. I look forward to our witnesses' participation, and, Lynn, would you have a comment?

Ms. RIVERS. No, Mr. Chairman.

Mr. BENTSEN. If I might, I don't have a comment, but I would like to welcome J. Kenneth Huff, Sr., of Whitesboro, Texas, who will be testifying today. He is the vice president for finance on AARP's board of directors and previously acted at the national secretary/treasurer of the association. Mr. Chairman, I just think that of all of the moves that you have made, this may be one of the best moves in having him testify. I welcome Mr. Huff.

Chairman SMITH. Certainly, I am not sure who is responsible for having this great Texas weather up here in Washington.

Mr. BENTSEN. It is actually cooler in Texas.

Chairman SMITH. Our other panelist is David Koitz, a specialist in Social Security legislation, education and public welfare for the Congressional Research Service. David has been working with CRS for 20 years and has become an expert on Social Security.

So with that, Ken, do you want to go first?

Mr. HUFF. It doesn't matter to me.

Chairman SMITH. Mr. Huff, why don't you go first with your testimony? All testimony will be included in the record, so if you could hold it to approximately 5 or 6 minutes and then be available for questions, that would be appreciated.

STATEMENT OF J. KENNETH HUFF, SR., VICE PRESIDENT FOR FINANCE, BOARD OF DIRECTORS, AND SECRETARY/TREASURER, AARP; AND DAVID KOITZ, CONGRESSIONAL RESEARCH SERVICE

STATEMENT OF J. KENNETH HUFF, SR.

Mr. HUFF. Thank you, Mr. Chairman and, for your kind remarks, Congressman Bentsen.

I am a volunteer. I am a member of the AARP board of directors. I am vice president of and still secretary/treasurer of the association. I live in a little town called Whitesboro, Texas, 3,250 people, in north central Texas, and we have a lot of Social Security recipients in that area.

AARP appreciates the opportunity to present its views regarding the Social Security Trust Fund. We know there is widespread confusion about the Social Security Trust Funds. This confusion that we have erodes public confidence in our Nation's primary income protection program and undermines the national consensus about strengthening the program for future generations.

The System is not in or near crisis. The Social Security trustees show that if no changes are made, the program could pay full benefits on time until 2034. That is a 2-year improvement from 1998 and 5 years longer than estimated in 1997.

Today the Trust Funds have a reserve of $850 billion. The FICA taxes, which workers and their employers pay in, are credited to specially designated Trust Funds in the Federal Treasury. After Social Security benefits and administrative benefits have been paid, any remaining money is invested in special issue government securities. Special issue bonds are redeemable prior to maturity. These securities, which are in essence a loan from Social Security to the government, are similar to the bonds issued by the Treasury and are backed by the full faith and credit of the government.

If Social Security did not have reserves to lend the Treasury, the government would have had to reduce other expenditures or find alternate sources of funding such as higher taxes, or issue additional debt. The government in times of deficit utilizes the funds that it receives from selling bonds to Social Security and other investors to help pay expenses. As we begin to move toward budget surpluses, Social Security's annual surplus would not be needed for government expenditures. Instead it would automatically be used to pay down the national debt.

The Trust Funds have more revenue than is needed for benefits through 2013. Beginning in 2014, Social Security expenditures will exceed incoming revenue, and interest earnings will be needed to honor currently promised benefits. The government would need sufficient revenue to pay Social Security's interest earnings just as it needs sufficient funds to pay any holder of government bonds.

Starting in 2022, incoming revenue and interest earnings will not fully cover benefits, and the Trust Funds' reserve will be drawn down until it is exhausted in 2034. Even without any Trust Fund assets, incoming revenue will fund over 70 percent of the benefits thereafter.

Social Security's investment policy has been characterized as a raid on the Trust Funds and the bonds described as worthless IOUs. However, this is not so. Mr. Chairman, Chairman Bill Archer stated in a November 20, 1998, interview with AARP's Bulletin staff, and let me quote, he said, "We are talking about a Social Security system that is not projected to run out of money for 34 years. All of the Social Security payroll taxes immediately go into government bonds, and those government bonds are the safest investment in the world. That money could never be used for anything but Social Security benefits."

That is the end of the quote. Mr. Chairman for the record, I have his complete interview that he gave to us at that time.

The Social Security Advisory Board noted that Congress has never allowed the Social Security program to reach the point that benefits could not be paid, and it is not expected to in the future. AARP believes that it would be prudent to act sooner rather than later. We need to move beyond a discussion of whether Social Security first faces financial difficulty in 2014 or 2034 or whether the Trust Funds hold worthless IOUs. Rather on the eve of the 21st century, what really counts is that we make the necessary decisions to put Social Security on sound financial footing for the future. This solution should maintain the program's guiding principles, ensure income adequacy, and achieve solvency in a fair and timely manner.

AARP looks forward to working with our elected officials on a bipartisan basis to ensure Social Security's continuing role as a foundation of income security for current, as well as future, beneficiaries.

This, Mr. Chairman, concludes my testimony.

[The prepared statement of Mr. Huff follows:]

PREPARED STATEMENT OF J. KENNETH HUFF, VICE PRESIDENT FOR FINANCE, AMERICAN ASSOCIATION OF RETIRED PERSONS

AARP appreciates the opportunity to present its views regarding the Social Security trust funds. Our own experience, supported by public opinion polls, suggest that there is widespread confusion about the size and use of the trust funds. As our elected officials broaden their dialogue with the American people about the Social Security program and its future, AARP hopes for improvement in the public's understanding of the role the trust funds play in financing current and future benefits. This information could increase confidence in the system as well as help forge public consensus about ways to strengthen the program for the long-term. We encourage Congress and the Administration to continue their efforts to move forward on Social Security solvency legislation. Prompt action means we can adopt more incremental solutions and gradually phase-in any changes, with adequate lead time for those now working.

While the program faces a long-term challenge, it is not in crisis. Social Security's trust funds have a reserve of $850 billion, which is invested in special issue, government securities. These securities earn an average interest rate of over 7 percent. AARP believes it would be prudent to adopt a long-term solvency solution now when Social Security is building a sizable reserve for the future.

I. Public Opinion and the Trust Funds

Any discussion about Social Security should be grounded in a solid understanding of the program, its financing, and the impact on the American people and their families of any changes to the program. Social Security is designed to protect workers against "the hazards and vicissitudes" they might face if they were left solely responsible for their own and their family's financial security upon the retirement, disability, or death of a breadwinner. The program provides a near universal, defined benefit that serves as the income base to which workers can add an employer-provided pension, as well as personal savings.

Public opinion polls consistently demonstrate that Americans of all ages strongly support Social Security and believe society should honor the long-term benefit commitment to people when they retire. Many people, particularly younger workers, lack confidence in the program's long-term viability. Their lack of confidence reflects concerns directly related to the program, such as the notion that the trust funds have been "raided," as well as concerns that have less bearing, such as a lack of faith in all institutions, including government.

A July 1998 poll by Harris and Teeter Research Companies for the Wall Street Journal found that 79 percent of the American people agreed that the Federal Government had used the Social Security trust funds for other purposes. (Only 13 percent did not). Similarly, this March, a Rasmussen Research poll showed that by more than 3 in 1 (60 percent to 19 percent) respondents believed that if the government kept Social Security money in a trust fund, our political leaders were more likely to spend the money than save it for the future. A poll released in May for National Public Radio, the Kaiser Family Foundation, and the Kennedy School of Government shows that 65 percent of those surveyed believe one of the major reasons why Social Security will be unable to pay benefits in the future is because the trust funds were stolen. This percentage is consistent with other polls and has remained steady over time.

Despite a lack of confidence in Social Security, most Americans (8 in 10) still want to know that Social Security will be there for them "just in case they need it." (DYG Inc., 1996) Those benefits can and will be available, but any reform effort will be made easier if a more informed public actively participates in the national dialogue about the future of Social Security.

II. The Trust Funds

A. the reality

Many people believe the system is in or near crisis, but this fear is unfounded. Social Security is the nation's most closely monitored Federal program, and the only one that projects future income and costs over 75 years. For most of Social Security's history, the program operated on a pay-as-you-go basis. Most revenue was immediately spent to pay benefits with only a modest trust fund reserve to cushion against an economic downturn. Starting in 1977, Social Security shifted toward partial pre-funding (advance funding)-a trend accelerated by the Social Security Amendment of 1983. As a result, the program has been taking in more revenue than it pays out in benefits and has been building up a larger reserve to help pay for the benefits of an increasing number of retired workers in the future.

The intermediate projections from the 1999 Social Security trustees' report indicate that without a single change to current law, the program can pay full benefits on time until 2034-a 2-year improvement from 1998 and 5 years longer than estimated in1997. The trust funds will continue taking in more revenue than is needed for benefits through 2013. Beginning in 2014, Social Security expenditures will exceed incoming revenue, and interest earnings will be needed to fully honor currently promised benefits. At that time, the government will have to have sufficient revenue to pay Social Security's interest earnings, just as it will need sufficient funds to pay interest to the holders of any government bond. Some suggest that Social Security will face a serious crisis in 2014 when incoming revenue falls short of expenditures. However, the government currently finds the necessary resources to honor its interest obligations to all its current bondholders, and it has never reneged on its debts.

Starting in 2022, incoming revenue and interest earnings will not fully cover benefits, and the trust funds reserves will be gradually drawn down until they are exhausted in 2034. Even without trust fund assets, Social Security's incoming revenue will finance over 70 percent of benefits for decades after 2034.

B. THE MYTHS

Lack of confidence in the program's ability to pay future benefits results from the view that the trust funds have been stolen and/or the trust funds hold worthless IOUs. In fact, workers and their employers' payroll tax contributions are credited to specially designated trust funds in the Federal Treasury. Any money collected that is not disbursed for benefits or to administer the program must be invested, as has always been required, in special issue, interest bearing government securities (or government-backed securities). The bonds are redeemable prior to maturity, if needed, at par value (i.e. without risk of principal price fluctuations). These securities, which are in essence a loan from Social Security to the government, have the same status as any other bonds issued by the Treasury and are backed by the full faith and credit of the government. Just as individuals loan the government their money when they purchase Treasury bills, notes, or savings bonds, Social Security loans its revenue to government. The government, in times of deficit, uses these funds to help pay for expenses such as highways, education, or food inspection. As we begin to move into fiscal surpluses, any reserves not needed for government expenditures are automatically used to pay down the national debt. Indeed, the House has already passed, and the Senate is currently considering, a Social Security "lockbox" mechanism better to protect these funds.

If Social Security did not have reserves to loan the Treasury, the government would have had to reduce expenditures, find an alternative source of funding such as higher taxes, or issue additional debt that would be purchased by other investors. The trust funds currently hold about 14 percent of the entire national debt, and private investors, including pension funds hold almost 70 percent of the remainder. The remainder of the debt is held by other government trust funds, such as the civil service and military retirement trust funds.

One common misperception is that the Social Security's government bonds are worthless IOUs. All government bonds represent future financial claims against future public revenue. Securities in the Social Security trust fund accounts, along with other Social Security revenues, give the Treasury the means to write Social Security checks. Just as a positive balance in a checking account means an individual can draw on that account, a balance in the Social Security trust funds means that checks can be written on the Social Security account.

While all government programs have Treasury accounts, for Social Security, the trust fund designation means that the total amount received by Social Security beneficiaries is not subject to the annual Congressional appropriation process. As long as there are balances in Social Security's trust fund accounts, benefits are paid with monies designated specifically for that purpose.

The Social Security trust funds represent a long-term commitment on behalf of the government to the American people. And, as long as the program has been in operation (64 years), all Social Security revenue has been used to pay benefits and administer the program, with any remaining funds used to purchase government securities, as required by law. There has been no "raid" or misappropriation of the Social Security trust funds.

III. THE FUTURE: ACTION IS NEEDED

In its July 1998 report, Why Action Should be Taken, the Social Security Advisory Board wrote, "Congress has never allowed the Social Security program to reach the point that benefits could not be paid, and it is not expected to in the future." AARP believes that it would be prudent to act sooner rather than later and well before the 75 million Boomers become eligible for retirement benefits in 2008.

We need to move beyond a discussion of whether Social Security first faces financial difficulty in 2014 or 2034. Rather, on the eve of the 21st century, what really counts is that we make the necessary decisions to put Social Security on sound financial footing for the future. Earlier remedial action is desirable to strengthen the fiscal health of the program, improve public confidence, and maximize the opportunity for individuals to adjust their plans.

The Association looks forward to participating on a bipartisan basis with our nation's elected officials to achieve a solution to Social Security's long-term problems. This solution should maintain the program's guiding principles, ensure benefit adequacy, and achieve solvency in a fair and timely manner. Social Security must continue its role as the foundation of lifetime income security for tomorrow's beneficiaries.

Chairman SMITH. David.

STATEMENT OF DAVID KOITZ

Mr. KOITZ. Chairman Smith, members of the Task Force, I am not here to refute or substantiate myths about Trust Funds. Perhaps you could see my role as one of clarifying how they work and what the balances and securities of the funds mean.

The costs of Social Security, both its benefits and administrative expenses, are and always have been largely financed by taxes on wages and self-employment income commonly referred to as FICA and SECA taxes. Contrary to popular belief, these taxes are not deposited into the Social Security Trust Funds. They flow into depository accounts across the country and always have. Along with many other forms of revenue, these taxes become part of the operating cash pool or what is commonly referred to as the U.S. Treasury. In effect, once these taxes are received, they become indistinguishable from other moneys that the government takes in. They are accounted for separately through the issuance of securities to the Trust Funds, and always have been, but this basically involves a series of bookkeeping entries by the Treasury Department. The Trust Funds themselves do not receive or hold money. They are simply accounts. Similarly, benefits are not paid from the Trust Funds, but from the Treasury. As the checks are paid, securities of an equivalent value are removed from the Trust Funds.

When more Social Security taxes are received and spent, the money does not sit idle in the Treasury, but is used to finance other operations of the government. The surplus is then reflected in a higher balance of Federal securities being posted to the Trust Funds. These securities, like those sold to the public, are legal obligations of the government. Simply put, the balances of the Social Security Trust Funds represent what the government has borrowed from the Social Security System plus interest. Like those of a bank account, the balances represent a promise that if needed to pay Social Security benefits, the government will obtain resources equivalent to the value of these securities.

While generally the securities issued to Trust Funds are not marketable, that is, they are issued exclusively to the Trust Funds, they do earn interest at market rates, have specific maturity rates, and by law represent obligations of the U.S. Government.

What often confuses people is they see these securities as assets for the government. When an individual buys a government bond, he or she establishes a financial claim against the government. When the government issues a security to one of its own accounts, it hasn't purchased anything or established a claim against some other person or entity. It is simply creating an IOU from one of its accounts to another.

I don't mean to suggest that its worthless. However, it is just one arm of the government making a commitment to another arm of the government. Hence, the building up of Federal securities in Federal trust funds, like those of Social Security, is not a means in and of itself for the government to accumulate assets. It certainly establishes claims against the government for the Social Security System, but the Social Security System is part of the government. Those claims are not resources that the government has at its disposal to pay future Social Security benefits.

Generally speaking, the Federal securities issued to any Federal Trust Fund represent "permission to spend." In the words of this committee and the Appropriations Committee, its budget authority. In other words, as long as a Trust Fund has a balance of securities posted to it, the Treasury Department has legal authority to keep issuing checks for the program.

In a sense, the mechanics of a Federal Trust Fund are similar to those of a bank account. The bank takes in the depositor's money, credits their account, and then loans it out. As long as the account shows a positive balance, they can write checks that the bank must honor.

In Social Security's case, its taxes flow into the Treasury, and its Trust Funds are credited with Federal securities. The government then uses the money to meet whatever expenses are pending at the time. The fact that this money is not set aside for Social Security purposes does not dismiss the government's responsibility to honor the Trust Funds' account balances. As long as those funds show balances, the Treasury Department must continue to issue Social Security checks.

The key point is that the Trust Funds themselves do not hold financial resources to pay benefits; rather, they provide authority for the Treasury Department to use whatever money it has on hand to pay them. If the Treasury lacks the resources to meet these claims, it must borrow them, or, alternatively, Congress would have to enact legislation to raise revenue or cut spending.

The significance of having Trust Funds for Social Security is that they represent a long-term commitment of the government to the program. While the funds do not hold "resources" that the government can call on to pay Social Security benefits, the balances of Federal securities posted to them represent and have served as financial claims against the government, claims on which the Treasury has never defaulted nor used directly to finance anything other than Social Security expenditures.

As a final point, I was asked to comment on how much of future Social Security benefits could be financed if the System did not have Trust Fund balances to rely on during the period from 2014 to 2034. While the System's Board of Trustees has projected that the balances of the Trust Funds coupled with the System's income would be sufficient to finance all Social Security costs until 2034, they estimate that the System's tax revenue will fall below the expenditures in 2014, 20 years earlier. In effect, at that point the government would be paying a portion of the System's benefits with general funds; that is, moneys that it would owe the System then from prior Social Security surpluses.

The question that I was asked is if, hypothetically, the Trust Fund balances did not exist in 2014 and interest was not accruing on them, how much of the benefits could be paid with the Social Security tax receipts flowing into the Treasury at that time. Based on the Trustees' 1999 intermediate or best estimate, about 99 percent of the projected benefits in 2014 would be payable with incoming Social Security receipts, including both payroll taxes and income taxes from the taxation of Social Security benefits. However, over the period from 2014 to 2034, the shortfall would grow steadily. In 2020, less than 85 percent of the benefits would be payable with incoming receipts. By 2034, only 71 percent would be. For the 2014-2034 period as a whole, the shortfall would be about 22 percent, meaning that only about 78 percent of the benefits would be payable. If this average shortfall existed today, it would amount to about $85 billion a year.

I would emphasize again that this is a hypothetical figure, and as such it is not a projection of the degree to which the System would be insolvent. Its significance is in representing the extent to which the government would be asked to support the System with its other resources. These government payments would be owed to the System, and as such would be an "asset" to the Social Security System, but not an asset to the government itself.

The basic point is that while considerable attention has been drawn to the System's projected point of insolvency, that is, the year 2034, the potential strain that the System may place on governmental resources could start much sooner.

Mr. Chairman, this concludes my statement.

Chairman SMITH. Thank you.

[The prepared statement of Mr. Koitz follows:]

PREPARED STATEMENT OF DAVID KOITZ, CONGRESSIONAL RESEARCH SERVICE

Chairman Smith and members of the Task Force, I was asked to provide you with an overview of the nature and operations of the Social Security trust funds.

WHERE DO SURPLUS SOCIAL SECURITY TAXES GO?

The costs of the Social Security program, both its benefits and administrative expenses, are largely financed by taxes on wages and self-employment income, commonly referred to as FICA and SECA taxes. Contrary to popular belief, these taxes are not deposited into the Social Security trust funds. They flow each day into thousands of depository accounts maintained by the government with financial institutions across the country. Along with many other forms of revenues, these taxes become part of the government's operating cash pool, or what is more commonly referred to as the U.S. treasury. In effect, once these taxes are received, they become indistinguishable from other monies the government takes in. They are accounted for separately through the issuance of Federal securities to the Social Security trust funds—which basically involves a series of bookkeeping entries by the Treasury Department—but the trust funds themselves do not receive or hold money.[1] are simply accounts. Similarly, benefits are not paid from the trust funds, but from the treasury. As the checks are paid, securities of an equivalent value are removed from the trust funds.

Yes. When more Social Security taxes are received than spent, the money does not sit idle in the treasury, but is used to finance other operations of the government. The surplus is then reflected in a higher balance of Federal securities being posted to the trust funds. These securities, like those sold to the public, are legal obligations of the government. Simply put, the balances of the Social Security trust funds represent what the government has borrowed from the Social Security system (plus interest). Like those of a bank account, the balances represent a promise that if needed to pay Social Security benefits, the government will obtain resources in the future equal to the value of the securities.

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[1] Public Law 103–296 requires the Secretary of the Treasury to issue "physical documents in the form of bonds, notes, or certificates of indebtedness for all outstanding Social Security Trust Fund obligations." Under prior practice, trust fund securities were recorded electronically.I74Does This Mean That the Government Borrows Surplus Social Security Taxes?

ARE THE FEDERAL SECURITIES ISSUED TO THE TRUST FUNDS THE SAME SORT OF FINANCIAL ASSETS THAT INDIVIDUALS AND OTHER ENTITIES BUY?

Yes. While generally the securities issued to the trust funds are not marketable, i.e., they are issued exclusively to the trust funds, they do earn interest at market rates, have specific maturity dates, and by law represent obligations of the U.S. government. What often confuses people is that they see these securities as assets for the government. When an individual buys a government bond, he or she has established a financial claim against the government. When the government issues a security to one of its own accounts, it hasn't purchased anything or established a claim against some other person or entity. It is simply creating an IOU from one of its accounts to another. Hence, the building up of Federal securities in Federal trust funds—like those of Social Security—is not a means in and of itself for the government to accumulate assets. It certainly establishes claims against the government for the Social Security system, but the Social Security system is part of the government. Those claims are not resources that the government has at its disposal to pay future Social Security benefits.

WHAT THEN IS THE PURPOSE OF THE TRUST FUNDS?

Generally speaking, the Federal securities issued to any Federal trust fund represent "permission to spend." As long as a trust fund has a balance of securities posted to it, the Treasury Department has legal authority to keep issuing checks for the program. In a sense, the mechanics of a Federal trust fund are similar to those of a bank account. The bank takes in a depositor's money, credits the amount to the depositor's account, and then loans it out. As long as the account shows a positive balance, the depositor can write checks that the bank must honor. In Social Security's case, its taxes flow into the treasury, and its trust funds are credited with Federal securities. The government then uses the money to meet whatever expenses are pending at the time. The fact that this money is not set aside for Social Security purposes does not dismiss the government's responsibility to honor the trust funds' account balances. As long as those funds show balances, the Treasury Department must continue to issue Social Security checks. The key point is that the trust funds themselves do not hold financial resources to pay benefits—rather, they provide authority for the Treasury Department to use whatever money it has on hand to pay them. If the Treasury lacks the resources to meet these claims, it must borrow them, or alternatively, Congress would have to enact legislation to raise revenue or cut spending. The significance of having trust funds for Social Security is that they represent a long-term commitment of the government to the program. While the funds do not hold "resources" that the government can call on to pay Social Security benefits, the balances of Federal securities posted to them represent and have served as financial claims against the government—claims on which the Treasury has never defaulted, nor used directly as a basis to finance anything but Social Security expenditures.

HOW MUCH OF THE SYSTEM'S FUTURE BENEFITS WOULD BE PAYABLE IF THE SYSTEM RELIED EXCLUSIVELY ON ITS TAX RECEIPTS?

As a final point, I was asked to comment on how much of future Social Security benefits could be financed if the system did not have trust fund balances to rely on during the 2014 to 2034 period. While the system's board of trustees has projected that the balances of the trust funds coupled with the system's income would be sufficient to finance all Social Security costs through 2034, they estimate that the system's tax revenues would fall below its expenditures in 2014. In effect, at that point the government would be paying a portion of the system's benefits with general funds, i.e., monies it would owe the system then from prior Social Security surpluses. The question I was asked is if, hypothetically, the trust fund balances did not exist in 2014 and interest was not accruing on them, how much of the benefits could be paid with the Social Security tax receipts flowing into the Treasury at that time. Based on the trustees' 1999 intermediate or best estimate, about 99 percent of the projected benefits in 2014 would be payable with incoming Social Security receipts, including both payroll taxes and income taxes resulting from the taxation of Social Security benefits. However, over the period from 2014 to 2034, the shortfall would grow steadily. In 2020, less than 85 percent of the benefits would be payable with incoming receipts. By 2034, only 71 percent would be. For the 2014–2034 period as a whole, the shortfall would be about 22 percent, meaning that only 78 percent of the benefits would be payable. If this average shortfall existed today, it would amount to about $85 billion a year. I would emphasize again that this is a hypothetical figure, and as such it is not a projection of the degree to which the system would be insolvent. Its significance is in representing the extent to which the Government would be asked to support the system with its other resources. These government payments would be owed to the system, and as such would be an "asset" for the system, but they would not be an asset for the Government itself. The basic point is that while considerable attention has been drawn to the system's projected point of insolvency—i.e., the year 2034—the potential strain that the system may place on governmental resources generally could start much sooner. Mr. Chairman, this concludes my statement. I'll be glad to take any questions you and other members of the task force may have.

Chairman SMITH. The Congressional Budget Office last year estimated that if there were no traumatic cuts in other expenditures, or if there were no additional public borrowing, total taxes would have to go up to 85 percent of earnings to accommodate continued payments of Social Security and Medicare within the next 40 years if there was no Trust Fund. Maybe the question is do you agree that paying back the Trust Fund is only as good as Congress and the White House's willingness to pay back that Trust Fund? In other words, the law could be changed like it was with the Transportation Trust Fund to wipe it out.

Both of you; Dave, you make a comment first, and then Ken.

Mr. KOITZ. In an abstract sense, the security for payments from the Social Security System comes from laws, from Congress and the administration. The balances of the Trust Funds have, for the most part, served as a contingency source of budget authority. When we get out to 2014, to 2020, 2025, with the projected impact of looming demographic changes, meaning the baby-boom generation of retirees coming on strong, and we don't have equivalent growth in the labor force to support it, we are going to have rapidly rising government expenditures for entitlements. I don't think that anyone can predict what is going to happen with discretionary spending and what the national debt is going to be, but it seems pretty obvious that the demographics are going to push up the cost of entitlements.

One of the ways that I would look at it is that the government's aggregate costs have been in the range of 19 to 23 or 24 percent for the last 60 years. Its revenue base has rarely exceeded 19 percent. This year it is up to 20; but rarely has it exceeded 19 percent. If we look at some of the CBO projections and other projections made by others, we see entitlement spending going up to 25, 30, or maybe 40 percent of GNP in the future. So I don't really think that you get the full picture if you focus only on the balance of the Trust Funds. I think that you have to look at the aggregate impact of the demographics, in particular on long-term entitlement spending.

Going back to something that you raised a moment ago, if we got out to 2014, in the absence of a budget surplus at that point, I think that you hit it right on the head: We would have to borrow money, raise taxes, or cut spending. But if we had budget surpluses, unified budget surpluses, that is, excess receipts flowing into the government in the aggregate, there would be a potential source of funds for these costs. I think the question is can budget surpluses be sustained through this period when we have rising entitlements? How long could we sustain them with the curve going up?

Chairman SMITH. So, Ken, maybe expand my question a little bit for your response. The government's choices are almost identical with or without a Trust Fund. If Washington is going to keep its commitment on benefits, then with the current estimate of 2014 for revenues to begin to fall short of benefits, one of three things will have to occur: Dramatical cuts in our spending, increased taxes, or increased public borrowing. So those three choices are the same with or without a Trust Fund. So how real is the Trust Fund?

Mr. HUFF. I agree. There is no question that when we get the 2014 and then move on to 2022, things are going to happen just as you enumerated. You are going to have to cut expenses or raise revenue or create the debt on it. I don't disagree with David's statement that 2034 becomes more

intense.

Chairman SMITH. Ken, in your testimony you said that maybe we should adopt incremental solutions and gradually phase in changes. You also say let's get at it and come up with a solution.

Mr. HUFF. Absolutely. What I meant to say is the same thing as 1983, make some changes that will lengthen the life of it. The same thing happened in 1983. As I said, we were almost bankrupt at that time. Yet these changes were made and it sustained the System up to now and into the future. We may have to do that from time to time in the years ahead.

Chairman SMITH. I have seen the AARP write in its magazine, there is no problem with Social Security until 2034. It has been suggested that we would hit about 75 percent of benefits. But that could be drastic, couldn't it, since roughly a third of our population depends on Social Security for 90 percent or more of its retirement.

David, what happens; have you projected those years after 2034, how much benefits would have to be cut below 75 percent in those subsequent years?

Mr. KOITZ. Well, if the Trust Fund falls to a zero balance in 2034, and at that point we are relying on tax revenues, it is basically the same question that you asked me to address in my testimony, only it occurs 20 years later. At that point, based on the actuary's projections, we would have the revenues to pay the equivalent of 71 percent of benefits. By the end of the projection period, 2075, I think that it drops below 68 or 69. I don't know the exact figure.

Chairman SMITH. It is out there. It keeps dropping.

Mr. KOITZ. But not as rapidly as in the next 25 years.

Chairman SMITH. Ken, has the AARP ruled out privately owned capital investment accounts as part of a potential solution?

Mr. HUFF. Do you mean privatizing the System?

Chairman SMITH. Having some privately-owned accounts within the System.

Mr. HUFF. We haven't ruled that out. Our policy says that we encourage supplemental accounts similar to what we have under IRAs and 401(k)s. The thing that we do not want, we do not want a carve-out of the existing payroll taxes benefits that go into the Fund. Anything that we might encourage to encourage savings, to get people to do these things, we are not opposed to that as long as it is supplemental to the Social Security System as we now know it.

Chairman SMITH. Lynn Rivers.

Ms. RIVERS. Thank you. I don't have a lot of questions because, frankly, I am sort of mystified by the point of the hearing today. Generally we hear from people who have proposals or who are suggesting ways to deal with issues that we are—that are a part of the debate. I am a little surprised because the facts that I heard today are pretty much the facts that I heard on a regular basis, that everybody is talking about, everybody. I am more concerned about how we are going to develop the strategy to redeem the Treasury instruments, which is really the question of the Trust Fund, at least in my view, how to address this.

Chairman SMITH. If you would yield, it just seems to me so important. AARP is the leading senior organization. Their reaction to go against politicians that come up with proposals, make it so important to go ahead to have them come and talk to us.

Ms. RIVERS. Come and say what about the Trust Fund?

Chairman SMITH. To the extent that the Trust Fund, they feel, is going to keep the program solvent and how important it is to act now.

Ms. RIVERS. Policymakers that help us move where?

Chairman SMITH. You are yielding?

Ms. RIVERS. Yes, I am.

Chairman SMITH. The burr is out from under the saddle, and we are moving ahead with reform this year. It seems to me unless people like the individuals on this Task Force can become a catalyst to continue moving the discussion ahead and hopefully moving the solution ahead, and I see senior organizations because of their concern, because of the importance of Social Security in their lives, as being instrumental in how we develop proposals and how much credit we give to that.

Ms. RIVERS. What I would like to do is be a part of any effort from any—with any group of people concerned about this to develop a strategy of how we face the redeeming of the instruments in the Trust Fund. If people are committed to finding a solution, that is why I am here. Thank you.

Chairman SMITH. Mr. Ryan.

Who was here first?

Mr. Toomey.

Mr. TOOMEY. Well, I for one would like to thank the Chairman for scheduling this. I think this is a useful discussion.

I just wanted to get some clarification, I guess, really as to whether or not there is agreement about one of the fundamental natures of the Trust Fund.

Mr. Huff, you indicated that you were in agreement with the other gentleman's opinion; that is, that there are no resources in this Trust Fund. I agree with that. That seems clear to me. But the testimony on page 4, it would seem to me, would differ from that. What I read in the last paragraph states, "Securities in the Social Security Trust Fund accounts, along with other Social Security revenues, give the Treasury the means to write Social Security checks. Just as a positive balance in a checking account means an individual can draw on that account"—it seems to me the exact opposite is the case. In fact, securities in the Social Security Trust Fund don't provide any means whatsoever. They simply create an obligation on the part of the Treasury to go out and find the means, which is rather different from actually possessing the means.

Mr. HUFF. Which paragraph?

Mr. TOOMEY. Last paragraph on page 4.

Mr. HUFF. Which says, Social Security did not have the reserves, the government would have had to reduce other expenditures, find alternate sources, or issue additional debt?

Mr. TOOMEY. That is not the page that I am reading, sir. Page 4 begins with, "One common misperception is that the Social Security's government bonds are worthless IOUs."

Mr. HUFF. Let me see if I can find it.

Mr. TOOMEY. Under Roman numeral IIB, Myths.

Mr. HUFF. All right. I was referring to my oral remarks, and you were referring to the written testimony that we have submitted. Let me read it to you, if I may.

"One common misconception is that the Social Security's government bonds are worthless IOUs. All government bonds represent future financial claims against future public revenue. Securities in the Social Security Trust Fund accounts, along with other Social Security revenues, give the Treasury the means to write Social Security checks. Just as a positive balance in a checking account means an individual can draw on that account, a balance in the Social Security Trust Funds means that checks can be written on the Social Security account."

I assume that what we are talking about there is the bonds are issued based upon the faith and credit of the Federal Government. As far as I know, they have never reneged on these. I put money in a bank up to $100,000 because the government guarantees that if that bank fails, that they will pay the funds. So basically what we are saying here is that regardless of even though the money is not there, the obligation is there by the Federal Government to replace those funds and honor the debits that they have against the fund.

Mr. TOOMEY. I don't dispute that the Federal Government will feel an obligation to make Social Security payments to seniors, but what I object to is the characterization that these bonds in the Trust Fund provide the means to write those things, or an asset to draw upon in the way that a positive balance in a checking account is.

Mr. HUFF. I see what you are saying, and maybe we need to make it more clear what we are talking about; that is that the trust funds establish an obligation.

Mr. TOOMEY. I appreciate that because I have had many conversations with my constituents in my district, and they feel there were assets just like a pile of gold in Fort Knox, and we know that that is not the case.

Mr. HUFF. I come from the State of Texas, and I have handled the accounting from the State of Texas for a number of years. We have our employees' retirement system, our teachers' retirement system. The money flows into those funds, and investors use those to buy securities. These may be obligations of a corporation. We depend on that and know that when we need the money to pay the benefits that accrue, that we can draw on that.

I can only assume that as 2014 rolls around, and we are going to have to start drawing, we are going to have to start paying some money in order to honor the benefits that are there. I just feel like there is not that much difference in what we are saying.

Mr. TOOMEY. Thank you.

Chairman SMITH. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I have a number of specific questions. Let me follow up on my colleague's comment. If all of us went to the bank tomorrow and decided that we would all withdraw our cash, I think that all of us know that the bank would not have the cash to pay everyone. In fact, I think that the way that the bank would get the money to pay is to go to the Federal Reserve; the Federal Reserve would buy back bonds for the cash to go into the system. The Trust works that way.

I would ask unanimous consent to insert into the record at this point both a copy of the specimen of the Treasury bond that is issued to the Federal Old Age and Survivors Trust Fund as well as the letter to me, in response to a letter that I wrote, from the Commissioner of Social Security from last year regarding interest on the Trust Fund, on bonds in the Trust Fund, as well as a cite from section 201(d) of the Social Security Act with respect to deposits in the Trust Fund.

Chairman SMITH. Without objection, so ordered. Are those actual size, Ken?

Mr. BENTSEN. It is the actual size of the specimen.

Chairman SMITH. Without objection, so ordered.

[The specimen referred to follows:]

THE UNITED STATES OF AMERICA

$XX,XXX,XXX,XXX

NO. 000000

THE FEDERAL DISABILITY INSURANCE TRUST FUND

Dated: 00/00/00

Due: 00/00/00

CUSIP: XXXXXXXXX

XX%

SPECIMEN

WASHINGTON, D.C.

SECRETARY OF THE TREASURY

BY

NOT TRANSFERABLE

[The letter referred to follows:]

OFFICE OF THE COMMISSIONER,
SOCIAL SECURITY ADMINISTRATION,
October 9, 1998.

Hon. KENNETH E. BENTSEN, JR.,
House of Representatives, Washington, DC.

DEAR MR. BENTSEN: This is in response to your letter of September 1, 1998, requesting an opinion on whether interest earned on the surplus payroll tax revenues is the property of the Social Security trust funds or is general revenue of the Federal government.

Section 201(f) of the Social Security Act states that "The interest on, and the proceeds from the sale or redemption of, any obligations held in the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund shall be credited to and form a part of the Federal Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, respectively * * * *" Section 201(d) of the Act states that "It shall be the duty of the Managing Trustee to invest such portion of the Trust Funds as is not, in his judgment, required to meet current withdrawals. Such investments may be made only in interest-bearing obligations of the United States * * *". Thus, by law, all income to the trust funds that is not immediately needed to pay expenses is invested in securities guaranteed as to both principal and interest by the Federal government and the interest from that investment belongs to the respective trust fund.

As you requested, I am enclosing the full text of the section of the Social Security Act that deals with this issue.

Sincerely,

KENNETH S. APFEL,
Commissioner of Social Security.

Mr. BENTSEN. This is actually sort of interesting. I want to get into the specifics of this.

First of all, the Trust Fund is legally created in Section 201 just in the same way that a trust indenture is created between a borrower and the lender, correct?

Mr. KOITZ. Sure.

Mr. BENTSEN. So there is a legal obligation that exists. I am trying to get away from a philosophical to a legal structural side.

There is a flow of funds that occurred that I think, Mr. Koitz, you talked about in part. Employees and employers pay their FICA tax. It goes into an administrative account in XYZ Bank which are all over the country, is ultimately pulled into the Treasury, and all Treasury funds become fungible. But then an entry is made into an account for purchase of a Treasury bond, which, by law, Social Security is required to invest in Treasury bonds backed by full faith of the Federal Government. So by purposes of the Trust Fund, they do receive an asset in the Trust of a book entry Treasury bond plus interest, correct?

Mr. KOITZ. Absolutely.

Mr. BENTSEN. The interest and the asset is, in part, determined by the fact that the bond pays interest. So it is not a par bond, zero interest bond, it is an interest-earning instrument or asset within the Trust Fund. So I am fairly comfortable with the flow of funds.

I think there is a philosophical argument or economic argument beyond which how much the government borrows in the gross sense and their ability to pay their debts, but that would affect the quality, would it not, of not just the Treasury bonds in the Old Age, but all Treasury bonds, because these bonds, which also by law they could either have special issue bonds or they could buy marketable bonds, but these bonds are not cheaper in the sense that the rate is different or richer in the sense that the rate is different than marketable Treasury bonds; is that correct?

Mr. KOITZ. That is correct.

Mr. BENTSEN. So they don't trade one way or the other.

In terms of the question that it is a contingency source of budget authority, do you mean by that within the sense of the Trust Fund itself being able to pay benefits or other types of governmental spending?

Mr. KOITZ. Absolutely, only the Trust Funds.

Mr. BENTSEN. OK. Now, if you have a completely private transaction where you go out and issue debt and you—under a trust indenture, and the funds flow into the general funds, in most cases those funds don't sit idle, but are invested in some interest-bearing account, money market or whatever, depending on what the withdrawals are going to be. So if you look at the account of the Trust Fund, it is not going to necessarily say cash on hand. It is going to say, Boston Company Money Market, No. 123, or something to that effect.

That is sort of how the Social Security Trust Fund works, is it not, that if you look at the Trust Fund, it says a whole list of U.S. Treasury bonds that are down and various rates of interest that are accrued; is that right?

Mr. KOITZ. I am not sure I agree with that. I think the basic thrust of your first few questions is whether the securities given to the Social Security Trust Fund are any different than any other Federal security. I have to say "yes" in form, but not in substance.

They earn interest, they have maturity dates, and the interest rates are based on what is going on with Federal securities in the marketplace. So in all important respects, or substantial respects, the securities of the Trust Funds are as real as the securities bought and sold in the financial marketplace.

However, this is where we get to be talking about apples and oranges with the issues. The fact that the government has given a commitment to Social Security is a form of asset for Social Security, but the question is, where does the Treasury get the money? If there is a strain on the Treasury, and I said there might not be because we might have budget surpluses, but if there were to be a strain on the government's financial resources in 2014 or 2020, 2025, 2030, where would we get the resources? We don't simply have a bump-up in costs. This is not analogous to a pig running through a python. What we have is continuously rising entitlement expenditures under almost anybody's projections.

What I am getting at is—the question isn't so much whether or not the Trust Fund securities are as real as any other government security, it is how does the government come up with the resources to make good on all of its——

Mr. BENTSEN. My time is running out, but this leads to my next question. The obligation to pay based upon those securities, based upon this security, is very real. If the government, this is my opinion, and I think it is a pretty sound one. My opinion is if we were to default on one of these securities, it would be akin to defaulting on a publicly held bond and would cheapen the debt of the United States, which would have a number of effects. So I think there is a legal trust. I think it is created by the same legal concept that if you and I went out and structured a private deal and a flow of funds.

The next question is is there a pledge for payment of benefits, current payment of benefits, beyond the assets of the Trust, a legal—not a philosophical, but a legal claim, or is it only against whatever the assets of the Trust are, and once they are depleted, they are gone?

Mr. KOITZ. No is the answer to your question, simply. The conditions for payment of Social Security are defined under benefit payment rules in the act, not by the size of the Trust Fund.

I go back to my analogy to budget authority. As long as you have a balance in that fund, there is a requirement for the Treasury Department to make good on the benefit commitments that are prescribed by the rules under the act. It is not a defined contribution system. It is not an IRA or a 401(k), where the assets to pay benefits flow out of the buildup of the accumulation in an account. Once the Trust Fund balance falls to zero, if we don't have enough tax revenues coming in then to cover the payments, there is nothing in the act that I know of or in any other act that says, you shall go on paying full benefits.

My best guess is, and it is based on past comments made by the Treasury Department, that if we got to that point—and as you said, we have never been there, we have always honored the payments of the Trust Funds—if we got to that point, the Treasury Department would delay payments.

Mr. BENTSEN. I think there are two different things. What you are saying is that if the Trust Fund was depleted, all paid off, that had become assets of the Trust Fund, and no more assets in the Trust Fund, and you didn't have enough revenue, annual revenues, to pay the full annual benefits, you are saying there is no pledge beyond what is there, cash on hand and accrued assets. I don't think that I agree with you, if bonds came due that were in the Trust Fund and Treasury is in a squeeze, that we would then decide to default on that. What we would probably have to do is roll bonds from government-held to public-held.

That raises other economic questions, but I don't think that we would agree that we would——

Mr. KOITZ. If I even gave you the implication of that, it was a misreading of what I said.

Mr. BENTSEN. That was my confusion.

Chairman SMITH. Mr. Ryan.

Mr. RYAN. I just had a couple of technical questions on this Trust Fund subject. You mentioned that the tax on benefits goes to Social Security. What other revenue sources outside of FICA taxes go to Social Security? Is it not—it is my understanding that after 1993, the tax bill, 50 to 85 percent doesn't go to Social Security, but goes to Medicare. Can you give me just a brief description of funding sources; what portion of it, if any, goes to Social Security, what goes to Medicare, and the earnings limit as well?

Mr. KOITZ. Social Security benefits first became taxable in 1984. Up to 50 percent of the benefits could be taxed under the 1983 amendments. That portion still goes to the Old Age, Survivors, and Disability Trust Funds. The provision in 1993 increased the taxation on those same people, going up to an 85-percent rate. That money is credited to the Hospital Insurance portion of the system.

You have got basically three sources of tax receipts. You have FICA taxes, which is the tax levied on wage earners, and shares paid by their employers; SECA taxes, self-employed taxes; and income taxes on benefits. Those are the cash sources of the Trust Fund. Then you have interest credited to the Trust Fund in the same form as marketable securities, as I mentioned before. That is done twice a year. Then, there are some very small general fund infusions; military gratuitous wage credits is the foremost one.

Mr. RYAN. How big is the revenue stream coming from tax on benefits?

Mr. KOITZ. I would have to guess—I think it is about $8 billion; not quite that much goes——

Mr. RYAN. $8 billion a year? That is not 50 percent that goes to Social Security. How big is the hospital fund?

Mr. KOITZ. $6 billion.

Mr. RYAN. That is very helpful. Thank you.

I yield back, Mr. Chairman. Reclaiming my time, I yield back.

Chairman SMITH. He yields back.

As you review history, several times when there is more money coming in from the Social Security taxes than was needed to pay current benefits, we expanded the program. So as you look at the increases in benefits over the year, it is substantial. Of course, the biggest changes to the Social Security Act was when we added Medicare. Likewise in our history when we were running out of money, when there was less money than needed, taxes were increased or benefits cut before it became time, Mr. Bentsen, to really call on some of these Trust Fund payments.

So we do have precedents that when we came close to calling on additional revenues of the Trust Fund, sometimes we have used those alternate funding sources. But likewise, in desperation, rather than paying back, rather than digging deeper into the Trust Fund, we have increased taxes. In fact, we have increased taxes something like 36 times since 1936.

So that is a little bit of my concern. How high can we increase taxes in the future, how much of an imposition is this going to be on economics expansion, and is it reasonable to put off the final decision until the solution becomes so desperate? I think time is not on our side and that the quicker we come and develop a solution, the more positive it is going to be as far as continuing our economic stream.

Ken, as an accountant and economist, your comments.

Mr. HUFF. I agree. I think we need to do something about it. First of all, we have a lot of people out there that don't believe it is going to be around when they retire. I think that if we make some arrangements and start fixing the problem, maybe we will increase confidence in the System. Quite frankly, if you go back, this is nothing new. Back in my days of Social Security, there were a lot of people then that didn't believe it would be there. Well, it is.

AARP supports fixing the problem and fixing it this year if we can. As I have mentioned to you, I think that when you get a fix, there is going to be a fix that is going to have some warts on it. I think that if we get together on a bipartisan meeting and try to fix the problem so that when we—so the fix won't be any more injurious than it would be if we wait several years to make the fix.

Chairman SMITH. David, do you have a comment?

Mr. KOITZ. Well, it is pretty hard to argue with the sooner that you can do it, the better, because you can then phase it in in smaller increments and get a fuller solution in the long run.

I guess the only additional comment I would make is that in the past, especially in 1977 and 1983, when we had fairly severe financial issues to deal with, we tended to focus on the issue by looking at average balance over 75 years. This was the focus of the debate both here on the Hill and in the press. I would say there is too much focus again on the average 75-year imbalance. It is like a magic bullet, that is, to achieve an average 75-year solution. I think that you have got to analyze at how any plan will achieve balance between income and outgo all of the way out, which means to 2075.

I think that was one of the problems with the 1983 amendments. The 1983 amendments largely showed average balances because they built up large reserves in the front end and shortfalls in the long run. I think that if we had acted on projections as to what that particular plan, that package of changes, would have done on a 10-year incremental basis or 5-year incremental basis all of the way out to the end of the 75-year period, I think perhaps Congress might have come to a different package of proposals. So my comment is look at what happens in 2075 as well as the average.

Chairman SMITH. The President has suggested adding another bond to the Trust Fund. When that is technically scored by the actuaries over at the Social Security Administration, they assume that all of this money is going to be paid back.

I think that has got to be an assumption that we are going to pay back the Trust Fund money, important as any other debt. Of course, the problem of paying it back is imposition on taxpayers or other funding programs. But that being the case, it still seems that the illusion of the Trust Fund by simply writing a $5 trillion IOU to the Trust Fund today and passing it in Congress, technically that would keep Social Security solvent for the next 75 years, but it really doesn't do anything to the huge problems and the imposition that we put on taxpayers and other spending programs. It seems to me this is a little bit illusionary to the Trust Fund in terms of somehow having to come up with the money to pay it back.

Any comments, and then we will move on.

Mr. KOITZ. You could get rid of this problem very quickly by crediting the Trust Fund with general revenues to the tune of something on the order of $3 trillion today. That money earning interest, supplemented by the current law revenue stream, would be sufficient to get rid of the problem over 75 years. But there are two levels of debate. One is what do you do with the Trust Funds; how do you keep that budget authority flowing? The second issue is where does the money come from? That perhaps is a tougher one, because if you have $3 trillion additional government securities posted to this ledger, the money has to——

Chairman SMITH. Aren't you sort of overstating it a little bit, that that would solve the problem by writing another giant IOU to the Trust Fund?

Mr. KOITZ. I am trying to distinguish between two levels. One is how do you deal with the imbalance of the numbers that the trustees have projected over the last 12 years? You could deal with that simply by crediting the Trust Funds with that amount of government securities. But that is not the real issue. The real issue, I think, at another level, is where does the government get the money to make good in 2034 on a piece of those balances?

Chairman SMITH. Representative Rivers.

Mr. Bentsen.

Mr. BENTSEN. On that point, you are right. It is a question of the amount of resources and the allocation of resources that you are looking at. What you are saying in making that comment is saying pouring into the general revenues a System that has been a dedicated source of funds coming in. That is, in part, what the administration proposed, I think, an ingenious way of—basically what they did, what they are proposing is to transfer publicly-held debt to Trust Fund-held debt by buying back publicly-held bonds in the name of the Trust Fund, just transferring the Trust Fund from one entity to another entity, but you still have a general revenue flow.

But I think, Mr. Chairman, for my purposes at least, this hearing of the Trust Fund, myth or reality, has to come to at least one conclusion; that is, if you look at the Code, the Trust Fund is a legal reality. The dedication of both revenues and assets are a legal reality. The question of a fund imbalance or benefit imbalance is a reality. It is a fiscal reality. And the question of whether or not the government spends too much money in the aggregate or is incapable in the future to service all of its debt is a fiscal reality. But the pledge within the Trust Fund is a legal reality, which is default on the bonds in the Trust Fund would be akin to a default on any other U.S. Treasury bond.

Mr. Huff, I want to say that I appreciate your testimony today because all of us on this panel and all of our colleagues in the House and the Senate have certainly heard from our constituents who say that there is no Trust Fund, ''you are just raiding the Trust Fund.'' That is not really accurate. What is going on is, I guess, government has leveraged the Trust Fund and its other Trust Funds, and in the broad scheme of things may raise its cost to borrowing in the future, including the ability to repay the bonds that are in the Trust Fund. But they are real, and we should make that point very clear. I think it is very commendable that AARP is taking this very responsible position in putting that word out.

Chairman SMITH. If the gentleman would yield. In effect, didn't we really default on the bonds in the Transportation Trust Fund when we wrote off that 22 or $24 billion?

Mr. BENTSEN. No. I would argue that we defaulted on the 1997 budget agreement because we just said we are going to come out—to evade caps, in effect, by about $20 billion. But we have not defaulted on any bonds.

Chairman SMITH. But we wrote off $22 billion of these sheets of paper to the Highway Trust Fund legislatively, and so that makes me very nervous——

Mr. BENTSEN. I would be glad to sit down and look at that more closely. I don't think that we did that. I think that what we did was we reallocated funds. The Trust Fund came out whole. That is the question—we did it legislatively.

Chairman SMITH. Let's look at it, but we did not pay the $22 billion. We wrote it off in exchange for taking the Highway Trust Fund out, $22 billion.

It is also a legal obligation, simply. Our Social Security law, we have a law that says we are going to pay these kinds of benefits based on this kind of structure for paying benefits. That is a legal obligation with or without the Trust Fund, it seems to me.

Mr. BENTSEN. I think, reclaiming my time, that is a very important question. Mr. Koitz's opinion is that the obligation only inures to the assets within the Trust Fund and current revenues. It is a legal question that I would encourage the Chairman to perhaps bring in some legislative—legal legislative scholars to give us their opinion as well. No doubt were we to get to that situation, and Congress were to be hard and fast, the matter would be litigated long after we are gone.

Chairman SMITH. Wrap-up comments in a minute or so by each of you, Mr. Koitz or Mr. Huff?

Mr. HUFF. We appreciate the opportunity to appear before the committee. We look forward to assisting in solving this problem. Our staff would stand ready to work with members of this committee.

Let me sum up by just reading something to you here. This was written by our Executive Director, that appeared in our bulletin here a short time ago. He says, "Social Security reform is dead only if the public allows it to be. AARP is not ready to write its eulogy yet. There is too much at stake for our members and future generations who will feel the impact of this reform the most. Ultimately, the problem is not a lack of ideas, it is a lack of consensus and trust, and the building blocks of reform are on the table. They need to be discussed and evaluated to see how they would work and whether or not they would ensure solvency and guarantee security. There is still time to achieve Social Security reform this year. Accomplishing this goal, however, depends upon whether our political leaders can trust each other enough to work out a solution and whether the public demands it."

Chairman SMITH. I would just make a footnote on that statement. When I was writing my first Social Security bill that included some private investing back in 1994, there was a tremendous misunderstanding of Social Security. When I met with the AARP specialists, they understood the problem and the consequences almost better than any other organization that I met with at that time. So my compliments.

Mr. HUFF. We would be happy to work with you.

Chairman SMITH. Mr. Koitz, closing comments.

Mr. KOITZ. I don't really have a wrap-up. However, I must say that I am not alone out there, based on the trustees' projections, that 2034 is a very difficult point for the System, and that in the absence of other changes, we couldn't pay full benefits. That is the position of the trustees. It also is the position of the President.

One other bit, perhaps a helpful comment to the committee, is that there is an American law, a CRS American Law memorandum, fairly recently, that addresses this question. I would be glad to furnish it to committee.

[The information referred to follows:]

TEXT OF CONGRESSIONAL RESEARCH SERVICE MEMORANDUM, DATED NOVEMBER 20, 1998

TO: House Committee on the Budget, attention Steven Robinson

FROM: Thomas J. Nicola, Legislative Attorney, American Law Division, Congressional Research Service

SUBJECT: Whether Entitlement to Full Social Security Benefits Depends on Solvency of the Social Security Trust Funds If Congress Does Not Change the Law

This memorandum responds to an inquiry regarding whether entitlement to full Social Security benefits depends on solvency of the Social Security Trust Funds if Congress does not amend the law to adjust eligibility requirements, benefit levels, or revenues. The Social Security Trust Funds are formally known as the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund, sometimes referred to as the OASDI Trust Funds. This question has been raised because of actuarial estimates of projected insolvency of the Trust Funds in the future.

The Social Security Trust Funds are not like private sector trust funds. There is no body of assets comprised of Social Security tax revenues that is held separately and managed for the benefit of participants in the Social Security system. Instead, the OASDI Trust Funds are accounts maintained on the books of the United States Treasury. General Accounting Office, "Treasury's Management of Social Security Trust Funds During the Debt Ceiling Crises," GAO/HRD–86–45, B–221077.2, 5 (1986).

The Social Security system operates on a "pay-as-you-go" basis in the sense that taxes paid now finance benefits for today's beneficiaries. Current workers and their employers and the self-employed pay taxes on wages and self-employment income under the Federal Insurance Contributions Act (FICA) and the Self-Employed Contributions Act (SECA), respectively, to the general fund of the Treasury rather than to the OASDI Trust Funds.

Social Security benefits are paid from the general fund of the Treasury. On the payment date, usually the third day of the month, a portion of the Treasury securities held by the OASDI Trust Funds is redeemed to reimburse the general fund for Social Security benefits paid by electronic funds transfer on that date. Additional securities are redeemed four to five business days later to reimburse the general fund for benefits paid by check on the benefit payment date. Actual payroll tax revenues received during the month are deposited directly into the general fund of the Treasury to keep it whole for the normalized tax transfer to the Trust Funds.

In months when Social Security revenues exceed the amount of Social Security benefits paid, the surplus is invested in Treasury securities. Each June 30, any surplus for the year, after correcting for actual payroll taxes received, is converted to long-term securities and credited to the OASDI Trust Funds. In months when revenues are lower than the amount paid in benefits, the Secretary must redeem short-term securities that had been sold to the Trust Funds during the year to cover the excess payments.

Securities credited to the Trust Funds earn interest at market rates, have specific maturity dates, and represent full faith and credit obligations of the United States government. Interest on them also is credited to the Trust Funds in the form of an equivalent amount of Treasury securities. Section 201 of the Social Security Act, codified at 42 U.S.C. § 401. Id. at 5–6. See Koitz, David, "Social Security Taxes: Where Do Surplus Taxes Go and How Are They Used?" Congressional Research Service Report No. 94–593 EPW 2–3 (updated Apr. 29, 1998).

The 1998 Annual Report of the Board of Trustees of the Social Security and Medicare (Hospital Insurance) Trust Funds, released on April 28, 1998, estimated that the OASDI Trust Funds would be credited with surplus income until 2020, when Trust Fund reserves would peak at $3.8 trillion. Those reserves then would be drawn down as persons born during the post-World War II baby boom retire and collect benefits.

The trustees estimated that the DI Fund would be exhausted in 2019 and that the OASI Fund would be depleted in 2034; on a combined basis they would be insolvent in 2032. Koitz, David, and Kollman, Geoffrey, "The Financial Outlook for Social Security and Medicare," Congressional Research Service Report No. 95–543 EPW 1–2 and 4 (updated May 7, 1998).

The trustees calculated that taxes paid to the OASDI Trust Funds would begin to lag behind expenditures in 2013, when the program would begin to rely in part on general revenues to finance interest payments on securities credited to the OASDI Trust Funds. In 2021, the reserve balance of the Trust Funds would begin to be drawn down. By 2025, $1 out of every $5 of Social Security outflow would depend upon general fund expenditures for interest payments and the redemption of government securities held by the Trust Funds. Id.

Balances in the Trust Funds are claims against the Treasury. When the securities comprising those balances are redeemed, the claims will have to be financed by raising taxes, borrowing from the public, or reducing benefits and other expenditures. Executive Office of the President, Office of Management and Budget, Budget of the United States Government Fiscal Year 1999: Analytical Perspectives 328 (1998).

The projected insolvency of the Social Security Trust Funds has raised a question regarding whether entitlement to benefits would be jeopardized as a matter of law. Social Security is an entitlement program. Section 202(a) of the Social Security Act, codified at 42 U.S.C. § 402(a), for example, states, in relevant part, that:

> (a) Old-age insurance benefits. Every individual who——
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> (1) is a fully insured individual (as defined in section 214(a)),
>
> (2) has attained age 62, and
>
> (3) has filed an application for old-age benefits or was entitled to disability insurance benefits for the month preceding the month in which he attained retirement age (as defined in section 216(1)(l)),
>
> shall be entitled to an old age benefit for each month * * *

Entitlement authority has been defined as:

> [a]uthority to make payments (including loans and grants) for which budget authority is not provided in advance by appropriation acts to any person or government if, under the provisions of the law containing such authority, the government is obligated to make the payments to persons or governments who meet the requirements established by law.

2 U.S.C. §§ 622(9) and 651(c)(2)(C), quoted in General Accounting Office, Accounting and Financial Management Division, A Glossary of Terms Used in the Federal Budget Process: Exposure Draft (Glossary) (Jan. 1993).

Budget authority is authority provided by law to enter into obligations that will result in immediate or future outlays involving Federal Government funds. 2 U.S.C. § 622(2), quoted in Glossary at 21.

The definition of entitlement authority emphasizes the obligatory nature of benefit payments under the law creating the entitlement. "Entitlements are created by 'rules or understandings' from independent sources, such as statutes, regulations, and ordinances, or express or implied contracts." Orloff v. Cleland, 708 F.2d 372, 377 (9th Cir.1983), citing Board of Regents v. Roth, 408 U.S. 564, 577 (1972), and Perry v. Sinderman, 408 U.S. 593, 601 (1972). See also Erickson v. United States ex rel. Department of Health and Human Services, 67 F.3d 858, 862 (9th Cir. 1995).

The Supreme Court in Flemming v. Nestor, 363 U.S. 603 (1960), elaborated on the relationship between a beneficiary's legal entitlement to receive Social Security benefits and the power of Congress to change that entitlement by amending the Social Security Act:

> Broadly speaking, eligibility for benefits depends on satisfying statutory conditions as to (1) employment in covered employment or self-employment (see § 210(a), 42 U.S.C. § 410(a)); (2) the requisite number of "quarters of coverage"—i.e., 3-month periods during which not less than a stated sum was earned—the number depending generally on age (see §§ 213–215, 42 U.S.C. §§ 413–415); and (3) attainment of the retirement age (see § 216(a), 42 U.S.C. § 416(a)). * * *
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> Of special importance in this case is the fact that eligibility for benefits, and the amount of such benefits, do not in any true sense depend on contribution to the program through the payment of taxes, but rather on the earnings record of the primary beneficiary. * * *
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> * * * each worker's benefits, though flowing from the contributions he made to the national economy while actively employed, are not dependent on the degree to which he was called upon to support the system of taxation. It is apparent that the noncontractual interest of an employee covered by the Act cannot be soundly analogized to that of the holder of an annuity, whose right to benefits is bottomed on his contractual premium payments.
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> It is hardly profitable to engage in conceptualizations regarding "earned rights" and "gratuities." Cf. Lynch v. United States, 292 U.S. 571 [1934]. The "right" to Social Security benefits is in one sense "earned," * * *
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> * * * But the practical effectuation of that judgment has of necessity called forth a highly complex and interrelated statutory structure. * * * That program was designed to function into the indefinite future, and its specific provisions

> rest on predictions as to the expected economic conditions which must inevitably prove less than wholly accurate, and on judgments and preferences as to the proper allocation of the nation's resources which evolving economic and social conditions will of necessity in some degree modify.
>
> To engraft upon the Social Security system a concept of "accrued property rights" would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands. * * * It was doubtless out of an awareness of the need for such flexibility that Congress included in the original Act, and has since retained, a clause expressly reserving to it "[t]he right to alter, amend, or repeal any provision" of the Act. § 1104, 49 Stat. 648, 42 U.S.C. § 1304. That provision makes express what is implicit in the institutional needs of the program.

Flemming at 608–610.

These passages indicate that legal entitlement to Social Security benefits depends on meeting eligibility standards set out in the Social Security Act. Recognizing the changing nature of the program and the need to predict future economic developments, predictions that may not be wholly accurate as Flemming v. Nestor noted, Congress has expressly reserved the right to "amend, alter, or repeal any provision" of the Social Security Act. 42 U.S.C. § 1304.

In addition to its power to adjust Social Security eligibility requirements and revenues, Congress appears to have created a fallback, at least on a month-to-month basis, if taxes and interest credited to the OASDI Trust Funds should not be sufficient to meet benefit payments. Section 201(a), 42 U.S.C. § 401(a), in relevant part, states that:

> * * *in any case in which the Secretary of the Treasury determines that the assets of either such [Old-Age and Survivors Insurance or Disability Insurance] Trust Fund would otherwise be inadequate to meet such Fund's obligations for any month, the Secretary of the Treasury shall transfer to such Trust Fund on the first day of such month the amount which would have been transferred to such Fund under this section as in effect on October 1, 1990, and such Trust Fund shall pay interest to the general fund on the amount so transferred on the first day of any month at a rate (calculated on a daily basis, and applied against the difference between the amount so transferred on such first day and the amount which would have been transferred to the Trust Fund up to that day under the procedures in effect on January 1, 1983) equal to the rate earned by the investments of such Fund in the same month under subsection (d) of this section.

This language authorizes the Secretary of the Treasury to borrow from the general fund, but any amount borrowed must be repaid. It appears to be stopgap authority designed to deal with temporary conditions that may prevent timely investments in nonmarketable government securities. Insolvency of the OASDI Trust Funds creates a much greater problem that this authority does not appear adequate to remedy in a comprehensive way.

A publication of the General Accounting Office has described the relationship between a beneficiary's legal right to receive the full amount of an entitlement payment and the amount that may be paid if there is a funding shortfall.

> Congress occasionally legislates in such a manner as to restrict its own subsequent funding options. * * * [E]ntitlement legislation [is] not contingent upon the availability of appropriations. A well-known example here is Social Security benefits. Where legislation creates, or authorizes the administrative creation of, binding legal obligations without regard to the availability of appropriations, a funding shortfall may delay actual payment but does not authorize the administering agency to alter or reduce the "entitlement."
>
> Even under an entitlement program, an agency could presumably meet a funding shortfall by such measures as making prorated payments, but such actions would be only temporary pending receipt of sufficient funds to honor the obligation. The recipient would remain legally entitled to the balance.

General Accounting Office, Office of General Counsel, I Principles of Appropriations Law 3–33–3–34, n. 21 (2d ed. 1991) (Principles).

During a Social Security budgetary crisis in 1983, then-Secretary of Health and Human Services Richard S. Schweiker testified that Congress had authorized borrowing between the Social Security Trust Funds and the Medicare Trust Fund, known as the Hospital Insurance (HI) Trust Fund, in 1981, to be repaid with interest. He indicated that pursuant to this authority, granted in Pub. L. No. 97–123, benefits could be paid through June 1983. He said that interfund borrowing was used three times: the OASI Trust Fund borrowed $581 million from the DI Trust Fund on November 5, 1982, $3.4 billion from the HI Trust Fund on December 7, 1982, and a total of $13.5 billion, $4.5 from the DI Trust Fund and $9.0 billion from the HI Trust Fund, on December 31, 1982. Recommendations of the National Commission on Social Security Reform: Hearings Before the House Comm. on Ways and Means, 98th Cong., 1st Sess., Serial 98–3, 222 (1983) (prepared statement of Richard S. Schweiker, Secretary of Health and Human Services).

The Secretary added that, "Since the borrowing authority has expired [it expired on January 1, 1983], the OASI will, in the absence of further legislation, be unable to pay retirement and survivor's benefits on time beginning in July 1983." Id. The Secretary's testimony appeared implicitly to acknowledge that a funding shortfall in the Trust Funds would delay paying Social Security benefits, but would not extinguish a beneficiary's legal entitlement to them.

While an entitlement by definition legally obligates the United States to make payments to any person who meets the eligibility requirements established by the law setting out the entitlement authority, a provision of the Antideficiency Act, section 1341 of title 31 of the United States Code, prevents an agency from paying more in benefits than the amount available in the source of funds available to pay them, in this case the OASDI Trust Funds.

This provision, in relevant part, states that:

> An officer or employee of the United States government or of the District of Columbia government may not——
>
> (A) make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation;
>
> (B) involve either government in a contract or obligation for the payment of money before an appropriation is made unless authorized by law; * * *

The Act prohibits making expenditures either in excess of an amount available in a fund or before an appropriation is made. In the case of Social Security benefit payments, the Act would appear to prohibit paying more money in benefits than the amount of the balance in the Trust Funds and the amount being credited to them. If the Funds should become insolvent, it appears that the Social Security Administration would be able to pay only an amount of benefits equivalent to Social Security receipts from payroll taxes and other sources as they are being received to avoid violating the Antideficiency Act's prohibitions. Section 201(a) of the Social Security Act, 42 U.S.C. § 401(a) appropriates Social Security taxes. Section 201(d), 42 U.S.C. § 401(d) makes interest on and proceeds from the sale or redemption of government securities held by the OASDI Trust Funds a part of the Funds and credits these amounts to them.

Violations of the Antideficiency Act are punishable by administrative and criminal penalties. Section 1349 of title 31 of the United States Code makes an officer or employee who violates the Act's prohibitions subject to appropriate administrative discipline, including, when circumstances warrant, suspension from duty without pay or removal from office. An officer or employee who knowingly and willfully violates the Act can be fined not more than $5000, imprisoned for not more than 2 years, or both. While there is a statute that provides a criminal penalty for knowing and willful violations, no one appears to have been prosecuted under it. II Principles at 6–90 (2d ed. 1992).

If the Antideficiency Act limits the amount of benefits that may be paid to the amounts that have been and are being credited to the Trust Funds, interesting questions arise as to whether a beneficiary who is paid only a portion of the benefit amount set out in the Social Security Act could file suit to be paid the difference. If the status of the Social Security Trust Funds should allow payment of only 75 percent of benefits, for example, could a beneficiary sue for the difference, the remaining 25 percent? If a beneficiary may file such a suit, what would be the likely disposition? If a beneficiary should succeed in obtaining a court judgment against the United States, would the individual be able to satisfy that judgment?

It appears that a beneficiary who does not receive a full benefit payment may be able to file a claim for the difference. Subsection (g) of section 205 of the Social Security Act, 42 U.S.C. § 405(g), grants a right of judicial review to any individual, after a final decision of the Commissioner of Social Security made following a hearing to which he was a party, irrespective of the amount in controversy. The action may be brought in a district court for the judicial district where the plaintiff resides or has a place of business and must commence within 60 days after the notice of decision was mailed or within such further time as the Commissioner allows. The court has power to enter, upon the pleadings and transcript of the record, a judgment affirming, modifying, or reversing the decision of the Commissioner. Findings of the Commissioner as to any fact, if supported by substantial evidence, are conclusive. The judgment of the district court is final, but may be appealed to the Court of Appeals and the United States Supreme Court.

Filing suit pursuant to section 205(g) appears to be the exclusive way to obtain judicial review of a determination by the Commissioner of Social Security to deny a claim, in our example, for the difference between a benefit payment of 75 percent that was paid and the remaining 25 percent set out in the statute as the full benefit. Subsection (h) of section 205 of the Social Security Act, 42 U.S.C. § 405, captioned "Finality of Commissioner's Decision," states that findings and decisions of the Commissioner after a hearing are binding upon all individuals who were parties to a hearing. It adds that:

> No findings of fact or decision of the Commissioner of Social Security shall be reviewed by any person, tribunal, or governmental agency except as herein provided. No action against the United States, the Commissioner of Social Security, or any officer or employee may be brought under section 1331 or 1346 of Title 28 to recover on any claim arising under this chapter.

Section 205(h) expressly bars any district court from hearing any case brought under section 1331 of title 28, which grants jurisdiction to district courts to hear civil actions arising under the Constitution, laws, or treaties of the United States, known as Federal question jurisdiction. It also precludes jurisdiction under section 1346 of title 28 of the United States Code. Sometimes referred to as the "Little Tucker Act," this section grants jurisdiction to district courts to hear claims against the United States for less than $10,000 that are "founded either upon the Constitution, or any act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated damages in cases not sounding in tort."

The Tucker Act itself, section 1491 of title 28, grants jurisdiction to the Court of Federal Claims for claims against the United States regardless of dollar amount founded upon the same bases as the Little Tucker Act. Section 205(h) of the Social Security Act, 42 U.S.C. § 405(h), does not expressly deny jurisdiction under the Tucker Act to the Court of Federal Claims to hear claims of any amount for Social Security benefits.

Jurisdiction to hear claims for Social Security benefits under the Tucker Act, however, appears to have been foreclosed by some decisions of the Court of Appeals for the Federal Circuit, the court that hears appeals of decisions by the Court of Federal Claims. In Marcus v. United States, 909 F.2d 1470 (Fed. Cir. 1990), a panel of the Court of Appeals for the Federal Circuit held that section 205(h) of the Social Security Act denied jurisdiction to the Court of Federal Claims pursuant to the Tucker Act to hear a claim for Social Security benefits, even when the beneficiary asserted that he was entitled to relief under the Constitution. See also Saint Vincent's Medical Center v. United States, 32 F.3d 548 (Fed. Cir. 1994).

Would a beneficiary be likely to prevail in a suit for the difference between the amount available in the Trust Funds and the entitlement amount set out in the Social Security Act, the 25 percent difference in our example? It appears that a district court may have authority to enter a judgment against the United States to a beneficiary who has exhausted administrative remedies and filed suit, but it may not order the United States to pay the amount in controversy. See III Principles at 14–5 (2d ed. 1994). The Supreme Court in Reeside v. Walker, 52 U.S.(11 How) 272, 275 (1850), held that no officer is authorized to pay any debt due from the United States, whether reduced to judgment or not, unless an appropriation has been made for that purpose. The Court cited article I, section 9, clause 7 of the Constitution, which states that, "No money shall be drawn from the Treasury, but in consequence of appropriations made by law; * * * ." See also Office of Personnel Management v. Richmond, 496 U.S. 414, 424–426 (1990), and Rochester Pure Waters District v. Environmental Protection Agency, 960 F.2d 180, 184–186, n. 2 (D.C.Cir. 1992), the latter of which observed that there may be an exception to the general rule announced in the Reeside case where a court orders an expenditure for a constitutional reason such as to remedy a violation of the Equal Protection Clause.

Congress has created on the books of the Treasury the OASDI Trust Funds, appropriated an amount equivalent to 100 percent of taxes received, and provided that interest on and proceeds from the sale or redemption of government securities held in the Trust Funds shall be credited to and form a part of them. Section 201(a) and (f) of the Social Security Act, 42 U.S.C. § 401(a) and (f). It also has stated that amounts credited to the Trust Funds are the only source of funds to pay benefits. Section 201(h) of the Social Security Act, 42 U.S.C. § 401(h). Consequently, it appears that unless Congress changes the law, a beneficiary would not be likely to obtain an amount or satisfy a judgment sufficient to cover the difference between the amount that the Trust Fund balances permit the Social Security Administration to pay and the full benefit amount prescribed in the Social Security Act.

Another interesting question is whether there is a source of funds other than the Social Security Trust Funds that a beneficiary may use to satisfy a court judgment against the United States for the difference between the amount paid and the full benefit, 25 percent in our example. Section 1304 of title 31 of the United States

Code establishes the Judgment Fund; it appropriates necessary amounts to pay final judgments, awards, compromise settlements, and interest and costs specified in judgments or otherwise authorized by law.

The Judgment Fund is available to pay a judgment, however, only if payment is "not otherwise provided for." 31 U.S.C. § 1304(a)(1).

> The question of whether payment is "otherwise provided for" is a question of legal availability rather than actual funding status. As a general proposition, if payment of a particular judgment is "otherwise provided for" as a matter of law, the judgment appropriation is not available, and the fact that the defendant may have insufficient funds at the particular time does not make the judgment appropriation available. 66 Comp. Gen. 157, 160 (1986); Department of Energy Request to Use the Judgment Fund for Settlement of Fernald Litigation, Op. Off. Legal Counsel, December 18, 1989. The agency's recourse in this situation is to seek funds from Congress, the same as it would have to do in any other deficiency situation.
>
> There is only one proper source of funds in a given case.

III Principles at 14–26 (2d ed. 1994).

In the case of Social Security benefits, the source of funds appears to be otherwise provided for in the OASDI Trust Funds. As noted earlier, section 201(h) of the Social Security Act, 42 U.S.C. § 401(h), states that benefits shall be paid "only" from amounts credited to the Trust Funds. As a result, it does not appear that a beneficiary, if successful in obtaining a court judgment against the United States for the difference between the amount paid and the full benefit amount, could satisfy the judgment from the Judgment Fund.

CONCLUSION

This memorandum has addressed whether insolvency of the Social Security Trust Funds may prevent a beneficiary from receiving the full amount of benefits prescribed in the Social Security Act if Congress does not amend the Social Security Act with respect to eligibility standards or payroll tax rates or take other budgetary action to meet the shortfall. Our research reveals that insolvency of the Trust Funds would not extinguish the legal right, i.e., the entitlement, of a beneficiary to receive the full amount of a benefit payment. Under the Antideficiency Act, however, the Social Security Administration would be able to pay only a benefit level equivalent to Trust Fund receipts as they become available. Under our finding, if an amount sufficient to pay only 75 percent of benefits is credited to the Trust Funds as Social Security taxes are received, for example, each beneficiary would receive only 75 percent of the benefit.

There appears to be legal authority granting jurisdiction to a district court to hear a case brought by a beneficiary who has exhausted administrative remedies to challenge payment of an amount less than the full benefit amount. It is possible that a court may enter a judgment in favor of a beneficiary who has filed suit, but the Supreme Court has held that a court generally cannot order officers of the United States to pay an amount unless it has been appropriated by Congress. Article I, section 9, clause 7 of the Constitution states that, "No money may be drawn from the Treasury, but in consequence of appropriations made by law; * * *"

In our example, an amount sufficient to cover 75 percent of benefits would represent the full amount that Congress has appropriated and made available for benefit payments. The Social Security Act appropriates to the Trust Funds 100 percent of Social Security taxes and provides that interest on and proceeds from the sale or redemption of government securities held in them shall be credited to and become part of the Funds.

As a result, it appears that a beneficiary who may obtain a judgment against the United States for the difference between the amount paid and the full benefit would have to await congressional action to adjust the Social Security Act or otherwise raise revenue to provide the Social Security Trust Funds with an amount sufficient to pay the full benefit.

Chairman SMITH. Thank you both very much. A special thank you to you, Mr. Huff, to take the time and making the effort to appear.

The next meeting of the Task Force will be next Tuesday, and the subject matter will be investments, the cost of those investments, and handling investments that guarantee no loss.

So thanks again. The Task Force is adjourned.

[Whereupon, at 1:30 p.m., the Task Force was adjourned.]

Secure Investment Strategies for Private Investment Accounts and Annuities

TUESDAY, JUNE 15, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12 noon in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Members present: Representatives Smith, Herger, Toomey, and Rivers.

Chairman SMITH. The Budget Committee's Social Security Task Force will come to order for the purpose today of examining secure investment strategies for private investment accounts and annuities talking with Steve Bodurtha and Dr. Warshawsky and Jim Glassman. There are going to be two votes and that means it is going to be 25 minutes from now when the final vote is finished, maybe 20 minutes. We will vote and come back.

So I think we will proceed for the next maybe 10 minutes and then with our excuses it is going to take maybe 15, 20 minutes for Lynn and I and the other Members to go vote.

It seems to me public understanding is one of the keys to successful Social Security reform. When Americans understand how serious the situation is or the consequences of doing nothing, I think they are going to be the pressure or the catalyst that encourages their representatives to move ahead with solutions. With the solvency of the system in question, what I have seen over the last 5 years is special interest groups are coming in to make sure that their territory is protected.

And so we have seen, first of all, senior organizations come in to say don't cut the COLA, don't cut any benefits in any way, and if you have to raise money some place else, do that. So a protectionism from seniors, from near retirees, certainly from young people that already have expressed their concern and skepticism of whether retirement benefits are going to be available for them when they retire, but at the same time at least the statistics that I have seen indicates that those young people are investing less of their own money.

It seems to me that workers with personal accounts will have investment choices that give them stable incomes in their golden years, but it will also give them ownership which is an assurance that politicians can't change or interrupt them. Today a representative from TIAA–CREF will tell us about the life annuity program used for investors.

Steve Bodurtha is in charge of Merrill Lynch's Customized Investment Group. He has 15 years of Wall Street experience in applying financial innovation to investment products. He has pioneered the discipline of protected growth investing which seeks to grow wealth while essentially totally eliminating risks. So Steve, thank you very much for taking time to be here today.

Dr. Mark Warshawski is director of research at the TIAA–CREF Institute which supports the non-profit financial service organization and pension system for workers in U.S. educational and research institutions. Dr. Warshawsky has authored numerous publications on pensions and retiree health benefit plans, individual annuities and life insurance, financial planning and asset allocation, national health expenditures, corporate finance in the securities market.

James Glassman serves as a resident scholar at the American Enterprise Institute, well known in Washington as a financial columnist for the Washington Post and host of the TechnoPolitics weekly PBS program on science and public policy. Mr. Glassman's articles have appeared in the New York Times, the Wall Street Journal, Forbes, and many other publications.

Chairman SMITH. And Lynn, would you have an opening comment?

Ms. RIVERS. No.

Chairman SMITH. If you will excuse us, we will return as soon as possible so the Task Force is temporarily in recess.

[Recess.]

Chairman SMITH. The Task Force will reconvene. Without objection, all of the prepared testimony will be entered in the record, and if you would hold your comments to some place between 5 and 7 minutes to give us time for questions, that would be good.

STATEMENTS OF STEVE BODURTHA, FIRST VICE PRESIDENT, CUSTOMIZED INVESTMENTS, MERRILL LYNCH & CO., INC.; MARK WARSHAWSKY, DIRECTOR OF RESEARCH AT THE TIAA–CREF INSTITUTE; JAMES GLASSMAN, DE WITT WALLACE-READER'S DIGEST FELLOW IN COMMUNICATIONS IN A FREE SOCIETY, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Chairman SMITH. Mr. Bodurtha, Merrill Lynch.

STATEMENT OF STEVE BODURTHA

Mr. BODURTHA. Thank you. Chairman Smith, Congresswoman Rivers, distinguished Task Force members. Thank you for inviting me to testify in this important forum regarding the development of secure investment strategies for personal retirement accounts and annuities in the context of Social Security reform.

At the outset, let me say that I am not here to discuss the merits of personal retirement accounts. Rather, I have been invited because of my knowledge of and experience in developing secure financial products that protect principal and provide investors the opportunity for significant growth potential. My testimony is limited to that subject.

Growth oriented investments, such as stocks, have historically provided the best opportunity to increase wealth over the long run. And yet, potential downside risk keeps many people from investing in stocks, even when long-term growth is the objective, in planning for retirement, saving for college, or meeting future health and parental care needs to name just a few examples. When aversion to risk stands in the way of investing for long-term growth, people may fail to achieve important financial goals.

To help with this problem, we at Merrill Lynch have pioneered the concept of protected growth investing, which combines participation in the long-term appreciation potential of growth assets, such as stocks, with protection of principal.

The purpose of protected growth investing is simple: To allow the pursuit of growth with limited risk.

Protected growth assets are financial instruments with features of both stocks and bonds. In recent years, an array of exchange listed, protected growth assets have been issued to meet varying investor needs. While each has its own unique set of terms, most protected growth assets share certain common features. When you buy a protected growth asset, you are purchasing an asset at an offering price that typically ranges between $10 and $1,000.

Protected growth investors will receive all or substantially all of their initial principal at maturity. Protected growth assets generally are structured as debt obligations or bank deposits. Some, however, may be in the form of a mutual fund or annuity. Because protected growth assets are issued or backed by financial institutions or other companies, the payment of principal at maturity and the returns, if any, depend on such issuers creditworthiness.

Most of Merrill Lynch's protected growth assets are listed and traded on the New York Stock Exchange or the American Stock Exchange. Protected growth assets such as equity link deposits and annuities generally will not be exchange listed, however. An illustration may provide a better idea of how protected growth investing works. I will use the example of one of our protected growth investment products called a MITTS for marketed index target-term security.

In this example, an investor in this MITTS security is entitled to receive the principal amount of the security let's say $10 plus a supplemental payment equal to 100 percent of the price appreciation excluding dividends in the ABC composite stock price index. And you can think of that as a generic example. It could be the S&P 500 or the Dow Jones industrial average to add some other examples.

That appreciation is measured between the offering date and the maturity date of the MITTS security. For this hypothetical example, all of the $10 initial principal amount is backed and protected by Merrill Lynch and Co. Investors in no event will receive less than the principal amount of $10 at maturity subject to Merrill Lynch's ability to pay its debt obligations regardless of how the stock index does.

This MITTS security provides that investors will receive a supplemental payment equal to 100 percent of the index's price appreciation, if any, between the original offering date and the maturity date. Let's look at three scenarios to understand what an investor will earn when they purchase such an investment. If the stock index is up, for example, 50 percent at maturity, an investor's return at maturity is the $10 principal amount plus a $5 supplemental payment.

The total final payment at maturity is $15. If the index is unchanged over the life of the investment, an investor's return at maturity is again the $10 principal amount plus no supplemental payment. As a result, the total final payment at maturity is $10. And if the index is down, for example, 50 percent at maturity, an investor's return at maturity will be $10 principal plus no supplemental payment. The total final payment in that case is $10 simply reflecting the return of the investor's principal.

There are several other important features that you should know about. One, most of the protective growth investments come in the form of bonds or deposits. An investor in these cases does not own stocks, and, therefore, they do not participate or receive dividends or have underlying voting rights with respect to the stocks. It is also fair to point out that not all of these investments give you full participation in the markets upside. In my example, I used a participation rate of 100 percent. It is possible that some of these investments may offer only 80 percent of the market's participation in the upside.

In addition, the protection mechanism is available at maturity. Between the offering date and maturity, the market price of these investments can fluctuate above or below the protection level, perhaps substantially. Also people should have in mind and keep in mind that there may be an opportunity cost associated with these investments. In the examples that I mentioned where the index is unchanged or goes down over the life of the investment, the investor simply receives their $10 initial principal back. They receive no credit, if you will, for the time value of money.

That concludes my oral testimony. My complete statement is submitted for the record. Thank you.

Chairman SMITH. Thank you.

[The prepared statement of Stephen Bodurtha follows:]

PREPARED STATEMENT OF STEPHEN G. BODURTHA, FIRST VICE PRESIDENT, CUSTOMIZED INVESTMENTS, MERRILL LYNCH & CO., INC.

INTRODUCTION

Chairman Smith, Congresswoman Rivers, distinguished Task Force members, thank you for inviting me to testify in this important forum regarding the development of secure investment strategies for personal retirement accounts and annuities in the context of Social Security reform. At the outset, let me say that I am not here to discuss the merits of personal retirement accounts in the context of Social Security reform. Rather, I have been invited because of my knowledge of, and experience in, developing secure financial products that protect principal and provide investors the opportunity for significant growth potential. My testimony is limited to that subject.

We at Merrill Lynch applaud the Task Force's ongoing efforts to meet the challenge of reforming Social Security in a manner that guarantees the long-term solvency of this vital program, increases national savings, and helps ensure that all Americans have an opportunity to retire in economic security. We look forward to assisting this Task Force, and Congress as a whole, in any way we can in achieving this critical task.

Pursuing Investment Growth While Limiting Risk

Growth-oriented investments, such as stocks, historically have provided the best opportunity to increase wealth over the long run. And yet, potential downside risk keeps many people from investing in stocks, even when long-term growth is the objective—in planning for retirement, saving for college, or meeting future health and parental care needs, to name just a few examples. When aversion to risk stands in the way of investing for long-term growth, people may fail to achieve important financial goals.

To help with this problem, Merrill Lynch has pioneered Protected Growth℠ investing, which combines participation in the long-term appreciation potential of growth assets, such as stocks, with protection of principal.

The purpose of Protected Growth℠ investing is simple: to allow the pursuit of growth with limited risk.

The Advantages of Protected Growth℠ Investing

Protected Growth℠ assets are financial instruments with features of both stocks and bonds. The benefits of Protected Growth℠ assets include protection of principal, growth potential of stocks, opportunity for diversification, low minimum investment and liquidity.

Protected Growth℠ assets promise to repay all or substantially all of their principal amount at maturity, even in the event of dramatic stock market price declines. The ability of a Protected Growth℠ asset to repay principal, of course, is subject to the creditworthiness of its issuer—that is, the company, financial institution or other entity that provides the principal protection.

Growth Potential

These assets offer the investor the opportunity to participate at maturity in the potential appreciation of an index, a stock portfolio, an individual security or some other potential growth opportunity. These growth opportunities are generically referred to as "market measures."

Diversification

Because Protected Growth℠ assets may be tied to a variety of market measures, they can complement the investment diversification of an investor's current portfolio mix of stocks, bonds, mutual funds and cash. The diversification available through these assets tends to be greater than what an investor may be able to achieve by purchasing individual equities.

Low Minimum Investment

Initial offering prices start as low as $10 per unit, providing the investor with an affordable means of participating in the performance of a number of different growth opportunities.

Liquidity

Most of Merrill Lynch's Protected Growth℠ assets issued to date are listed on the New York Stock Exchange, or the American Stock Exchange. This generally allows the investor to buy and sell Protected Growth℠ assets, as well as monitor daily price quotations published in the financial pages of major newspapers.

Protected Growth℠ Assets Key Features

In recent years, an array of exchange-listed Protected Growth℠ assets have been issued to meet varying investor needs. While each has its own unique set of terms, most Protected Growth℠ assets share certain common features.

When you buy a Protected Growth℠ asset, you are purchasing an asset at an offering price that typically ranges between $10 and $1,000.

Protected Growth℠ investors will receive all or substantially all of their initial principal at maturity—making principal protection a key feature of Protected Growth℠ investing.

Protected Growth℠ assets generally are structured as debt obligations or bank deposits. Some, however, may be in the form of a fund, or annuity. Because Protected Growth℠ assets are issued or backed by financial institutions or other companies, the payment of principal at maturity and the return, if any, depend upon such issuers' creditworthiness.

Protected Growth^{SM} investing typically offers the opportunity to participate in the growth of a particular market measure. This participation is usually stated in percentage terms and is referred to as a "participation rate." As an example, a 100 percent participation rate would give an investor the right to receive 100 percent of the price appreciation of a market measure, while a 90 percent participation rate would give the investor the right to receive 90 percent of such appreciation.

In certain instances, investors' participation in a market measure may not begin until the market measure has appreciated above a specific minimum level, sometimes referred to as a "minimum threshold." Also, participation rates may specify a maximum return level or "ceiling."

Protected Growth^{SM} assets usually are offered with a final maturity date. Maturities can range from one to 5 years or more.

Protected Growth^{SM} assets typically do not make regular interest or dividend payments to investors, and purchasing a Protected Growth^{SM} asset does not constitute ownership of the underlying securities or index comprising the market measure. As a rule, the market measure to which Protected Growth^{SM} assets are linked is specified at the time they are originally issued.

Most of Merrill Lynch's Protected Growth^{SM} assets issued to date are listed and traded on the New York Stock Exchange, the American Stock Exchange or NASDAQ between the time of their initial issuance and their final maturity date. Protected Growth^{SM} assets such as equity-linked deposits and annuities generally will not be exchange-listed, however.

PROTECTED GROWTH^{SM} INVESTING HYPOTHETICAL EXAMPLE

An illustration may provide a better idea of how Protected Growth^{SM} investing works. Consider the following hypothetical Market Index Target Term Security SM (MITTS).

GENERAL DESCRIPTION

At maturity, an investor in this MITTS security is entitled to receive the principal amount of the security ($10) plus a supplemental payment equal to 100 percent of the price appreciation (excluding dividends) in the ABC Composite Stock Price Index between the offering date and maturity date of the MITTS security.

OFFERING PRICE

The initial offering price of this MITTS security is $10.

PRINCIPAL PROTECTION

For this hypothetical example, all of the $10 initial principal amount is backed by Merrill Lynch & Co., Inc. (rated Aa3/AA-). Investors in no event would receive less than the principal amount of $10 at maturity, subject to Merrill Lynch's ability to pay its debt obligations, no matter how the ABC Index performs.

PARTICIPATION RATE

This ABC Index-linked MITTS security provides that investors will receive a supplemental payment equal to 100 percent of the Index's price appreciation, if any, between the original offering date and maturity date of the issue.

MATURITY DATE

This ABC Index-linked MITTS security matures 5 years after the issue date.

HYPOTHETICAL RETURN SCENARIOS

1. *Index Up*—ABC Index is up 50 percent at maturity. An investor's return at maturity is the $10 principal plus a $5 supplemental payment. The total final payment is $15.
2. *Index Unchanged*—ABC Index is unchanged at maturity. An investor's return at maturity is the $10 principal plus no supplemental payment. The total final payment is $10.
3. *Index Down*—ABC Index is down 50 percent at maturity. An investor's return at maturity is the $10 principal plus no supplemental payment. The total final payment is $10.

REASONS TO CONSIDER PROTECTED GROWTH^{SM} INVESTING

Protected Growth^{SM} investing allows investors to participate in growth opportunities that otherwise may be too volatile for their risk tolerance. The result is preservation of capital with long-term growth potential. Here are some of the ways these investments can help satisfy various needs and objectives.

BUILDING AND PROTECTING WEALTH

If an investor's financial plan dictates a need for growth, but they are reluctant to take the risks of buying stocks or other investments, Protected Growth^{SM} assets may be an attractive alternative. For example, retirees who need growth to hedge against inflation over two or three decades of retirement, but don't want to risk principal loss, may find these assets an attractive choice. Parents or grandparents investing for a child's college education may buy Protected Growth^{SM} assets to maintain appreciation potential while limiting downside exposure as the child's college years grow near.

MAINTAIN AND ADD TO EQUITY EXPOSURE DURING UNCERTAIN TIMES

If investors are concerned that the market is near a peak or do not wish to be exposed to turbulent market fluctuations, they can lock in accumulated stock market gains by reducing their existing direct equity holdings and using Protected Growth^{SM} investing to continue participation in potential future market advances.

BENEFIT FROM INDEX-BASED INVESTING

Even professional money managers may find it difficult to outperform market indices consistently over the long term. Committing a portion of assets to index-linked Protected Growth^{SM} instruments can be a sensible strategy, particularly in volatile markets when stock selection can be more challenging.

ENHANCE INVESTMENT PERFORMANCE

Protected Growth^{SM} investing may be an effective method of boosting potential returns on money investors may have idle in low-earning bank accounts and money market investments without greatly increasing their risk. Protected Growth^{SM} investing may give investors a way of adding high-quality growth assets to balance a portfolio that is otherwise over-weighted by fixed-income instruments.

STAYING THE COURSE

Some investors tend to sell on price declines and thus fail to benefit from the long-term growth potential of stocks. The principal protection available with Protected Growth^{SM} investing can make it easier to stay with a well-planned investment strategy and remain invested even during the most turbulent times.

A WAY TO PURSUE NEW INVESTMENT OPPORTUNITIES WITH LIMITED RISK

If investors have an interest in investing in specific markets or sectors around the globe or in certain strategies, but do not want the risk of owning the investments directly, Protected Growth^{SM} investing may offer a sound choice.

OTHER IMPORTANT FEATURES

Protected Growth^{SM} investing was created for investors willing to accept a specified level of participation in a growth opportunity in exchange for a known degree of principal risk. Investors who are willing to assume greater risk may want to invest directly into stocks and other growth investments for potentially higher long-term returns. In addition, Protected Growth^{SM} Investing usually is not appropriate for investors seeking current income.

NO DIVIDENDS PARTICIPATION OR VOTING RIGHTS

Protected Growth^{SM} assets do not provide the investor with direct ownership of stocks and typically do not provide participation in dividends paid by any stocks that may be included within the market measure. Furthermore, Protected Growth^{SM} assets do not convey any voting rights.

DIFFERENT TERMS AND FEATURES

Each Protected Growth^{SM} instrument has its own particular structure. While most pay only at maturity, some make annual payments or provide a minimum yield on the original principal. Still others have participation rates greater than or less than 100 percent.

MATURITY DATES

Maturities vary from issue to issue. However, most Protected Growth℠ assets are offered with original maturities of one to 5 years or more.

CREDITWORTHINESS OF ISSUER

The timely payment of principal at maturity and the market-linked return, if any, depend on the issuer's or backing institution's ability to pay. Protected Growth℠ assets typically are backed by highly creditworthy financial institutions or companies, most of which are rated A or better. Keep in mind that Protected Growth℠ notes and deposits are not mutual fund investments, and investors have no ownership rights in the underlying market measure.

LIQUIDITY

While Protected Growth℠ investing is designed for long-term investors, investors can typically sell investments prior to maturity. However, like most equity and fixed income investments, the price investors receive when they sell may be higher or lower than the price they paid. Of course, if they hold the investment until maturity, their principal is protected according to the terms of the issue.

MARKET PRICE FLUCTUATIONS

Remember that Protected Growth℠ assets can be viewed as a cross between stocks and bonds, and their market value prior to maturity may not track closely the performance of the market measure, particularly in the early years. Investors must be sure to look at the specific terms and understand the various factors that may affect the market price of each particular Protected Growth℠ issue.

UNDERSTANDING THE PRINCIPAL PROTECTION LEVEL

If investors purchase a Protected Growth℠ asset in the secondary market, they should be aware that their protection at maturity is based on the principal amount of the original offering. For example, if an investor pays $12 per unit for an issue with 100 percent protection of its $10 original principal amount, they will have $2 of principal at risk for every unit bought. On the other hand, if an investor pays $8 per unit of that issue, the issuer is still obligated to pay the investor at least $10 per unit, giving the investor a minimum return of $2 per unit.

TAXATION

Investors should consider the tax consequences of Protected Growth℠ investing. For Protected Growth℠ notes or deposits issued after August 12, 1996, any return earned by investors is considered to be ordinary interest income even if they sell the investment prior to maturity. In addition, the investor is likely to owe tax annually on imputed income, even though the return, if any, is typically paid at maturity.

OPPORTUNITY COST

Investors who purchase Protected Growth℠ assets typically give up interest or dividend payments. Protected Growth℠ assets may protect only some or all of the original investment and should be purchased by investors who do not require current income or the assurance that they will earn a return on their investment.

Chairman SMITH. Dr. Warshawsky.

STATEMENT OF MARK J. WARSHAWSKY

Mr. WARSHAWSKY. Good afternoon, Chairman Smith and members of the Task Force. I am pleased to speak at this meeting which gives a good opportunity to review research and information relevant to understanding some of the considerations for the use of life annuities as the primary or only method of distribution from individual accounts under various Social Security reform proposals.

According to the Social Security Administration, Office of the Actuary, in 1998, a woman age 62 could expect to live to age 84 while a 62-year-old man could expect to live to age 80. The life expectancy statistics I have just cited are expectations, that is, averages. If at retirement you knew your exact date of death, you could schedule a draw down of pension and personal assets so that the flow depleted those assets just at the moment of death. In reality, however, almost everyone is uncertain about how long they will live.

Again, according to the Social Security actuary, a woman aged 62 currently has a 25 percent chance that she will live until age 92 and a 10 percent chance that she will live until age 97. Is there a way of ensuring people that will have a sufficient income in these extra years? There is. It is called the life annuity. In its most basic form, an annuity whether issued by a life insurance company, an employer pension plan, or a government program such as Social Security, pools the mortality risks of people together. It pays out a higher flow of income, about 30 percent, to each participant for his or her entire lifetime than if the individual were left to his or her own devices.

Four arguments have been put forward over the years to provide a rationale for the mandatory provision by Social Security of old age annuities rather than voluntarily through the private market. Foremost of these arguments is that there is a significant moral hazard problem. Moral hazard is a term of art among social scientists. If individuals accumulate or are given a large sum of money at retirement to enable them to support themselves comfortably in old age, a significant percentage will willfully or accidentally spend or lose their retirement assets quickly and be forced to rely on public assistance programs for their sustenance. The mandatory provision of life annuities is judged to be necessary because it is thought that ultimately public support programs will be widely utilized and to maintain the dignity of the age.

The second problem that a mandatory system is suggested to solve is adverse selection, which is also a term of art used by actuaries and economists. This problem occurs if individuals with higher than average mortality risks such as those with serious illness conclude that annuities are too expensive for them and thereby avoid the purchase of annuities. If this avoidance behavior is widespread, insurance companies will price annuities with the truncated market in mind, and life annuities would be priced less attractively. Hence, the benefits of pooling mortality risks would be reduced to those in need of it. Mandatory provision of annuities helps reduce the adverse selection problem.

A third problem mentioned is not unique to individual annuities but is attributed broadly to many individual insurance and financial products. Marketing costs which can include massive advertising campaigns may include some socially wasteful expenditures.

The final problem sometimes mentioned for individual annuity markets is the lack of inflation indexation.

The questions of moral hazard and adverse selection can be handled largely by mandating annuitization of individual accounts through the private market. The question of inflation indexation can also be addressed at least partially through the private market. Since the issuance of inflation index bonds by the Treasury and other borrowers and the nascent formation of derivatives markets for these securities, insurance companies can also begin to design and issue inflation sensitive life annuities.

For example, my own company, TIAA–CREF, recently introduced an inflation index bond account that can be used for variable life annuity payouts. And as I have explained in research papers which I have shared with staff, providers of individual annuities, again referring to TIAA–CREF's experience, have also devised several types of annuities that provide for increases in income as the annuitant ages.

I thank you for your kind attention to my remarks and I would be glad to answer your questions.

[The prepared statement of Mark Warshawsky follows:]

PREPARED STATEMENT OF DR. MARK J. WARSHAWSKY, DIRECTOR OF RESEARCH, TIAA–CREF INSTITUTE

Good afternoon, Chairman Smith and members of the Task Force. I am Mark Warshawsky, Director of Research at the TIAA–CREF Institute, the financial and economic research and education arm of TIAA–CREF. Founded in 1918, TIAA–CREF is a nonprofit financial services company and the nation's largest private pension system, providing defined contribution pension plans to almost 2 million workers in the nonprofit education and research sectors and making retirement income payments to almost 300,000 annuitants. I am pleased to speak at this meeting which gives a good opportunity to review research and information relevant to understanding some of the considerations for the use of life annuities as the primary or only method of distribution from individual accounts under various Social Security reform proposals. Any opinions I express are my own and do not necessarily represent the official position of TIAA–CREF. I have shared with your staff two research publications providing more details than time allows in my remarks this afternoon.

Many study groups and bills introduced in Congress have come out in favor of some form of individual account system to supplement or partially replace the traditional defined benefit-indexed annuity structure of Social Security. Hence, for the first time since the 1930's, it is sensible to address, as your Task Force is doing, first-principle questions concerning the payout phase of any Federal retirement income program.

According to the Social Security Administration, Office of the Actuary, in 1998, a woman age 62 could expect to live to age 84, while a 62-year-old man could expect to live to age 80. The life expectancy statistics I have just cited are expectations, that is, averages. If, at retirement, you knew your exact date of death, you could schedule a draw down of pension and personal assets so that the flow depleted those assets just at the moment of death. In reality, however, almost everyone is uncertain about how long they will live. According to the Social Security Actuary, a woman age 62 currently has a 25 percent chance that she will live until age 92, and a 10 percent chance that she will live until age 97. Is there a way of insuring that people will have a sufficient income in these "extra" years?

There is. It is called the life annuity. In its most basic form, an annuity, whether issued by a life insurance company, an employer pension plan, or a government program, pools the mortality risks of people together. It pays out a higher flow of income (about 30 percent) to each participant for his or her entire lifetime than if each individual were left to his or her own devices.

Four arguments have been put forward over the years to provide a rationale for the mandatory provision by Social Security of old age annuities rather than voluntarily through the private market. These arguments maintain that there are problems in the operation of a voluntary private market for individual life annuities.

Foremost of these arguments is that there is a significant moral hazard problem. If individuals accumulate or are given a large sum of money at retirement to enable them to support themselves comfortably in old age, a significant percentage will willfully, or accidentally, spend or lose their retirement assets quickly and be forced to rely on public assistance programs for their sustenance. A milder form of the moral hazard problem is that individuals will underestimate their life expectancies, avoid the purchase of individual annuities, and spend down their assets completely before most of them die, again forcing many to rely on public or private charities for continued existence. The mandatory provision of life annuities is judged to be necessary because it is thought that ultimately public support programs will be widely utilized, and to maintain the dignity of the aged.

The second problem that a mandatory system is suggested to solve is adverse selection. This problem occurs if individuals with higher than average mortality risk, such as those with serious illness or with inherited predispositions toward certain diseases, conclude that annuities are too expensive for them, and thereby avoid the purchase of annuities. If this avoidance behavior is widespread, and it is impossible for insurance companies to sell low-priced annuities exclusively to low life expectancy individuals, insurance companies will price annuities with a truncated market in mind, and life annuities would be priced less attractively to those expecting relatively short lives. Hence, the benefits of pooling mortality risks would be reduced to those in need of it. Mandatory provision of annuities helps reduce the adverse selection problem.

A third problem mentioned is not unique to individual annuities, but is attributed broadly to many insurance and financial products marketed to individuals. Marketing costs, which can include massive advertising campaigns and large commission fees for brokers and agents, may include some socially wasteful expenditures. The final problem sometimes mentioned for individual annuity markets is a lack of inflation indexation. Unlike Social Security since 1972, individuals covered exclusively by fixed annuities purchased in the private market would have been exposed to unexpected increases in the rate of inflation.

Before I introduce some evidence on these problems, a general consideration can be posed against these arguments. No matter how complex or complete the benefit structure of a Federal Government compulsory program, it cannot possibly take into account the variety of individual situations and preferences. Competitive private markets and organizations, by contrast, reflect more immediately and completely the changing and variable desires and needs of individuals and respond more quickly to new ideas and financial technologies. In my papers, I have devoted several sections to the remarkable innovations in the private annuity market over the years, many of which I am proud to say that TIAA–CREF introduced. And yet other innovations are possible now.

On the question of whether moral hazard is a significant problem, the evidence is suggestive, but not conclusive. The fact that the poverty rate increases with age in the over-age-65 population is suggestive of a moral hazard problem. Perhaps because they take lump-sum or periodic distributions from their retirement plans and fail to purchase life annuities as they age, individuals use up their financial resources and rely solely on public retirement income programs. Similarly, because individuals fail to purchase long-term care insurance, they fall to Medicaid to support them as they require long-term care. While some individuals purchase single premium immediate annuities (SPIAs) and seem to choose reasonable payout forms and features, commercial market activity is still relatively small. The behavior of TIAA–CREF participants is more reassuring on this score, but it must be recalled that employer sponsors of TIAA–CREF plans historically required annuitization of all assets accumulated through their pension plans, and TIAA–CREF still recommends annuitization as appropriate for most of its participants.

On the question of whether adverse selection is a problem, there is evidence from studies which I have authored or co-authored that there is a difference in the mortality experience of the general population and annuity purchasers and that the difference imposes a not insignificant cost on individual annuities.

As I mentioned earlier, the questions of moral hazard and adverse selection can be handled largely by mandating annuitization of individual accounts through the private market. The question of inflation indexation can also be addressed, at least partially, through the private market. Since the issuance of inflation-indexed bonds by the US Treasury and other borrowers, and the nascent formation of derivatives markets for these securities, insurance companies can also begin to design and issue inflation-sensitive life annuities. For example, CREF recently introduced an inflation-indexed bond account that can be used for variable life annuity payouts. As I explain in my papers, providers of individual annuities, especially TIAA–CREF, have also devised several types of annuities that provide for increases in income as the annuitant ages.

Thank you for your kind attention to my remarks. I will be glad to answer any questions.

Chairman SMITH. Mr. Glassman.

STATEMENT OF JAMES K. GLASSMAN

Mr. GLASSMAN. Thank you, Mr. Chairman. Mr. Chairman, Congresswoman Rivers, and members of the Task Force, I am honored that you have asked me to testify here today on this very important subject.

My name is James Glassman. I am the DeWitt Wallace-Reader's Digest Fellow in Communications at the American Enterprise Institute and for the last 6 years, I have been a financial columnist for the Washington Post and I have just completed a book on the stock market titled "Dow 36,000," which will be published by Times Books in September.

I am also a great admirer, Mr. Chairman, of your efforts to reform Social Security. I am a strong supporter of allowing all Americans to participate in the growing American economy through stock ownership. It is really a shame that so many Americans, especially the young and the less well-off, have missed the opportunity to participate in the increase in the stock market since 1982 from 777 on the Dow to well over 10,000. One reason they have missed that opportunity to participate is that many of the dollars that could be saved or could have gone into stock market investing have been diverted into payroll taxes into a system by which Americans will get very low returns under Social Security.

You asked specifically that I address the question of how to insulate personal retirement account holders from losses and as the—and to provide adequate retirement income as the system changes—when and if the system changes. I have three answers to your question on insulation.

First, complete insulation against risk is impossible. No one investment is entirely risk-free, not even Treasury bonds. Treasury bonds can lose their value, lose their buying power in a significant way with inflation. There is a new class of Treasury bond, however, that does provide some protection. But in general, a complete insulation against risk is impossible. The only way that Social Security payments themselves are protected is through the taxing power of the Federal Government.

Second, in an uncertain world, investors have their best chance of gaining a secure retirement income and avoiding losses by making continual investments in a diversified portfolio of stocks over a long period of time. This is what I personally preach, probably too much, twice a week in the Washington Post. The reason is not only do stocks return a lot more than bonds but over long periods of time, stocks are actually less risky when we define risk as we do most of the time in financial terms as volatility, the extremes of the ups and downs of returns. And let me just quote Jeremy Siegel from the Wharton School in his book, "Stocks in the Long Run:" "Though it may appear to be riskier to hold stocks and bonds, precisely the opposite is true," writes Professor Siegel. "The safest long-term investment for the preservation of purchasing power has clearly been stocks, not bonds."

Unfortunately, however, many Americans, most Americans have been frightened out of long-term investing in the stock market to the degree to which they should be invested.

Therefore, that brings me to the third—my third point, which is that despite the excellent returns and low risks of stocks, because of this risk aversion, many investors, many Americans who are not investors now need other kinds of vehicles. Just let me give you an example of what Americans will be missing if they put all their money into bonds instead of stocks, and I use the Ibbotson statistics.

I know that Roger Ibbotson has testified in front of this committee. From 1925 to 1997, an investment of $1 in large company stocks rose to $1,828 while investment of $1 in long-term government bonds rose to just $39. So it is important that people are invested in the long-term in stocks. What's the best way to do that and protect them on the downside?

Well, there are many very interesting investment vehicles, one of which Steve Bodurtha has described here provided by—developed by Merrill Lynch & Co. Called MITTS or market index target term securities. Steve described them at length. They were launched about 7 years ago and they trade on major exchanges but few investors seem to be aware of them. Paine Webber, Solomon Smith Barney, Lehman Brothers and other firms also provide similar vehicles. The point about MITTS is very simple. There is no downside risk or very, very little downside risk. It is kind of like a bond but instead of being paid interest, you get paid the appreciation of a particular stock index in the case of one that I think that people should be—should think about for this kind of investing, the Standard & Poor's 500 stock index which reflects the activity of roughly the largest 500 stocks on the U.S. stock exchanges.

There are also, as Mark Warshawsky explained, annuities. There are many vehicles that can limit risk while providing large upside returns of the sort that the stock market provides. These kinds of vehicles serve as a response to the argument that individuals will lose their shirts if they are allowed to make their own choices about investing for their retirements. In fact, the technology and the imagination currently exist to limit risk on the downside in a trade-off for trimming slightly the gains on the upside. It is a deal that many Americans would gladly accept.

In summary, Mr. Chairman, and members of the Task Force, complete insulation from risk is impossible but the kind of risk reduction that prospective retirees want and should have is not only possible but is here today. Thank you.

Chairman SMITH. Thank you very much.

[The prepared statement of James Glassman follows:]

PREPARED STATEMENT OF JAMES K. GLASSMAN, DEWITT WALLACE-READER'S DIGEST FELLOW IN COMMUNICATIONSIN A FREE SOCIETY, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

I am honored that you have asked me to testify here today on this very important subject.

My name is James K. Glassman, and I am the DeWitt Wallace-Reader's Digest Fellow in Communications at the American Enterprise Institute. For the past 6 years, I have also been a syndicated financial columnist for the Washington Post, and, with the economist Kevin Hassett, I have just completed a book on the stock market, titled "Dow 36,000," which will be published by Times Books this September.

You asked that I specifically address the question of how to insulate personal retirement account holders from losses and provide adequate retirement income—when and if the current Social Security system changes from a defined-benefit system of government-guaranteed annuities to a defined-contribution system in which individuals own their own retirement accounts and are allowed broad choice in deciding the investments that will comprise them.

I have three answers to your question on insulation.

First, complete insulation is impossible. No investment is entirely risk-free, not even Treasury bonds. When inflation rises, the buying power of the interest and principal on bonds declines. Jeremy Siegel of the Wharton School at the University of Pennsylvania examined data going back to 1802 and found that over one 20-year period, bonds lost an annual average of 3 percent of their value.

Social Security payments themselves are protected only because the Federal Government has the power to tax. That is important to keep in mind. The only way to be sure that someone will get increased Social Security benefits, after inflation, is to tax someone else.

Second, in an uncertain world, investors have their best chance at gaining a secure retirement income and avoiding losses by making continual investments in a diversified portfolio of stocks over a long period of time.

This statement may seem counter-intuitive, but anyone who has studied the stock market knows that it is correct and actually uncontroversial.

The least risky way to invest for the long-term is by owning stocks, stocks and more stocks.

Kevin and I have written an entire book on this subject, but to summarize. * * *

While over short periods, stocks are highly risky, over longer periods, research by Siegel and others shows clearly that stocks not only produce higher returns than bonds, but are also less risky.

For example, over holding periods of 20 years, when the worst average annual performance by bonds was minus-3 percent, as I noted, the worst average annual performance by stocks was plus-1 percent. Unlike bonds or even Treasury bills, stocks have never produced a negative return for any holding period of 17 years or longer.

As Siegel writes: "Although it may appear to be riskier to hold stocks than bonds, precisely the opposite is true: the safest long-term investment for the preservation of purchasing power has clearly been stocks, not bonds."

Over the past 70 years, stocks have produced returns averaging 11 percent annually, roughly twice the returns of bonds. Since 1871, stocks have outperformed bonds in every holding period of at least 30 years.

"Risk" in financial terms is defined as volatility—the extremes of the ups and especially the downs of the returns that stocks produce, year to year.

History is no guarantee of the future, but it is the best guide we have. And history confirms that for long-term investors—and this, by definition, is what investors would be in a system that allows the private personal investment of some or all of the payroll tax dollars that now go to Social Security—stocks are both less risky and more lucrative than the alternatives.

The best vehicles for stock investing are broadly diversified mutual funds—either index funds that track the Standard & Poor's 500 index or the Wilshire 5000 index, or funds managed by individuals and teams. More than 3,000 U.S.-equity funds now exist. The choices are copious and attractive.

Third, despite the excellent returns and low risks of stocks over the long term, many individuals are extremely averse to what they perceive to be the riskiness of stocks. This aversion may be irrational—economists have studied what's called the "equity premium puzzle" for decades—but it is undeniable.

Americans who fear stocks may make the terrible mistake of putting their retirement dollars into money-market funds, Treasury bills or bonds. From 1925 to 1997, an investment of $1 in large-company stocks rose to $1,828 while a $1 investment in long-term government bonds became just $39, according to Ibbotson Associates, a Chicago research firm.

Another example: A one-time investment of $10,000 twenty years ago plus additional monthly investments of $100 became $416,000 in the Vanguard Index 500 fund, which tracks the S&P large-company stock index. By comparison, even an excellent fund, Dodge & Cox Balanced, with assets roughly divided 60 percent stocks and 40 percent bonds, under the same circumstances, grew to just $258,000—a difference of $158,000.

But there are interesting alternative equity investments that provide guarantees against loss while at the same time no restrictions on gains. The most popular of these were developed by Merrill Lynch & Co. and are called MITTS, or market index target-term securities.

Although the first MITTS were launched 7 years ago and trade on the American Stock Exchange, few investors seem to be aware of them. Paine Webber, Salomon Smith Barney, Lehman Brothers and other firms offer similar vehicles.

A MITTS security trades just like an individual stock, but it is tied to a particular basket of stocks, or index. Let's use the example of Merrill's first MITTS series, which was sold to the public in January 1992 at $10 a share. Each share was really like a bond because it carried a promise to pay investors back, in August 1997, the original $10-plus an amount equal to the percentage increase in the S&P 500 over that period, plus an extra 15 percent of that, times $10.

There was another promise: If the S&P was lower in 1997 than it was in 1992, investors wouldn't be penalized. Merrill would still return the entire $10 initial investment.

When the shares were issued, the S&P was 412. Five years later, it was 925. That's an increase of 125 percent. Add 15 percent of that and you get a total increase of 143 percent—times $10 equals about $14 per share. Add the original $10, and the shares were worth $24.

MITTS come in lots of flavors. Merrill offers MITTS linked to a technology index, a health care index, a European index and more.

Another MITTS guarantees a return of the original $10 plus an adjustment for increases in the consumer price index. Paine Webber's mid-cap security, similar to MITTS, is geared to mid-cap stocks and matures in June of next year. It came out at $10, which is guaranteed in the year 2000, but it currently trades at $25.

The Merrill S&P 500 is a natural investment for a personal retirement account. A series that began in 1997 offers a guaranteed return of principal plus the increase in the S&P index over 5 years with a bonus of 1 percent. Think of these instruments as bonds which, instead of paying a fixed 7 percent interest a year, instead pay "contingent interest" in a lump sum at the end of several years. The interest is contingent, or dependent, on what happens to the S&P 500. And even if the S&P falls, the interest can't be negative. You will get your principal back.

What's the catch? First, the bond (if you think of it that way) is an obligation of Merrill Lynch & Co., or another issuing party—not of the Federal Government. If the issuing party defaults, an investor could be in trouble. This problem has been partially handled, however, by creating instruments that combine a bank deposit, backed by Federal insurance, with an S&P 500-growth feature. But the insurance goes up only to the Federal limit of $100,000.

Second, an investor gets no dividends from the index. Even in the current low-dividend environment, the money that you forgo can be 15 percent or more of the original investment in 5 years. Over an extended period, it is not a trivial amount.

Third, there are negative tax consequences for these instruments if they are held in taxable accounts. The Federal Government treats MITTS as though they were zero-coupon bonds, and investors must pay taxes on phantom income before they receive it.

Fourth, these investment firms are not charitable institutions. They are offering instruments that are profitable to them. The truth is that in only seven out of 69 rolling 5-year periods since 1926 have stocks failed to make money. Investors are being insured against an event that has only a 10 percent likelihood of occurring. Stocks have lost money in only 3 percent of all 10-year periods since 1926.

But the securities—and similar annuity vehicles issued by insurance companies—provide an important service to risk-averse Americans.

They serve as a response to the argument that individuals will lose their shirts if they are allowed to make their own choices about investing for their retirements. In fact, the technology and the imagination currently exist to limit risk on the downside in a tradeoff for trimming gains on the upside. It is a deal that many will gladly accept.

In summary, complete insulation from risk is impossible, but the kind of risk reduction that prospective retirees want is not only possible, but also here today.

Thank you, Mr. Chairman.

Chairman SMITH. Mr. Bodurtha, the first question is how do you hedge or how do you take positions on the future markets to back your guarantees?

Mr. BODURTHA. There are a variety of ways in which Merrill Lynch would hedge the obligation that creates when it issues a product like a MITTS. And I guess the best analogy to use is that Merrill Lynch in this role is functioning a little bit like an insurance company. We are—instead of insuring someone's home against some other risk, we are ensuring the client, the investor against the risk of possible market declines. So the primary way in which we protect ourselves is to run, if you will, a diversified book of risks. We, like an insurance company, get a lot of benefit out of diversifying our business and doing this type of business with both our institutional or retail customers.

From time to time, we will enter into stock trading, futures trading, and things like that to hedge some of the risk; but I would say that that represents only a portion of the activity that we conduct. We can also interact with other large-scale institutional investors, including insurance companies and pension funds who, for a price, are willing to help provide this kind of downside protection.

Chairman SMITH. Is there a minimum length of time that you say this has got to be at least 5 years or whatever?

Mr. BODURTHA. No. The maturities on these investments generally range from 1 to 10 years, those that are publicly available. It is possible—I am aware of some of these investments that have been structured going out even longer so the technology exists to address even a 20- or 30-year time horizon.

Chairman SMITH. Bill Shipman said, at least in his earlier book, that there was no 12-year period that didn't result in a positive return on the index stocks. Roger Ibbotson said and I didn't quite understand it, Mr. Glassman, but I think he said that a 20-year period would result in the highest positive return as far as the length of time even though you have got ups and downs. Is that consistent with what you and Mr. Warshawsky suggest?

Mr. GLASSMAN. I am not sure that—if you look at 20-year periods or 1-year periods, over time the average return should be about the same. I think the key question really is risk over long periods. The longer you go out, the longer the period is, the lower the risk. And there has never been, according to Siegel's research, there has never been a period longer than 17 years in which the stock market has not produced a positive return after inflation which is a pretty amazing statistic. And those periods go all the way back to 1802, and they are overlapping periods, 1802 to 1818, 1803 to 1819, and so forth. History is no guarantee of the future, but it is pretty clear that the longer you go out, the more risk is reduced.

Chairman SMITH. Representative Rivers, this is going to be sort of self-serving here. I am going to talk about my bill just a little bit. I think there is a growing number of people, Republicans, Democrats, the President, that have suggested that some capital investment is going to be part of the solution for ultimately deciding how we make Social Security secure.

Some have suggested government should control the investments. Others have suggested, letting individuals invest wherever they want to invest. That was my first bill back in 1995 that I wrote that said anything that was eligible for an IRA investment would be eligible for this retirement investment. The bill I introduced last session suggested that it should be limited to certain more safe investments such as index stocks, index bonds, index small cap funds or index global funds, sort of the thrift savings limitation on investments.

Can I get each of your reactions to your feelings or thoughts on what kind of capital investments should be incorporated in Social Security reform?

Mr. GLASSMAN. Well, I can answer that. First of all, I think that—unfortunately I think investments have to be mandatory and

I think people must be fully invested during the entire period, until whenever their retirement starts. I don't think that the government should mandate particular investments. I think it is perfectly reasonable to have some kind of requirements for investment companies to qualify as—to qualify for investment vehicles, but I think that if an individual, as today with the 401K plan, wants to put all of his or her money into Treasury bills or money market fund, I think that would be a huge mistake but I think that is perfectly reasonable.

I mean, I understand people who feel that way. I think over time they would be educated in a way where they wouldn't be doing that.

Chairman SMITH. Mark or Steve have a comment?

Mr. WARSHAWSKY. There are a couple of points to make about some of these issues. One is there definitely is a trade-off, and it is a very difficult trade-off between the political issues that are involved in centralized investments versus the costs, the inevitable administrative costs which are involved in decentralized individual investments. So it is a very difficult balancing act that I think would need to be made.

The other consideration in terms of the types of investments to offer if they were to be offered in individual accounts is what—particularly at the outset—is what people can understand and what they can be educated about. We, at TIAA–CREF, are very careful when we introduce a new account. We are very careful that it be introduced with full explanation and that it truly represent a new type of an asset class as opposed just to introducing a new account for its own sake because it introduces a lot of confusion and sort of diversification for no real purpose.

So I think it is very important if Congress does decide to go down that road, to have asset classes and investment choices which are very carefully crafted and limited, certainly initially, because of the educational needs.

Chairman SMITH. Mr. Bodurtha.

Mr. BODURTHA. I would say if Congress does elect to make more investments eligible for Social Security, two criteria to those that have been discussed already would be creditworthiness to the extent that you have obligations, bonds and so forth eligible for Social Security. I would focus on some standard for creditworthiness. You might also focus on liquidity, giving investors the ability to change their mind and make adjustments in their financial planning as they go forward.

Chairman SMITH. Representative Rivers.

Ms. RIVERS. Thank you, Mr. Chairman. I have a couple of questions. To Mr. Warshawsky, you were talking about annuities. Are annuities a good deal in terms of yes, you get security, but are they a good deal financially for people who purchase them?

Mr. WARSHAWSKY. Well, the type of annuities that I was addressing in my comments are life annuities in terms of the payout phase. In other words, they are not what is typically discussed in the typical market in terms of as an accumulation product, but what I was referring to was the actual payout over a lifetime.

And the answer to your question is in general yes and it depends. It depends on where the annuity comes from, whether it is an individual product or whether it comes through a pension plan or sort of a group arrangement and so the answer depends. I think in general the answer is yes, though, because an annuity represents a type of insurance against the possibility of outliving your assets which is basically not available anywhere else.

Ms. RIVERS. Are they expensive?

Mr. WARSHAWSKY. Again, the answer is it depends.

Ms. RIVERS. Is this the sort of security or the sort of insulation of risk that most people would be able to avail themselves of or do you have to have a substantial amount of money to put this kind of annuity together initially?

Mr. WARSHAWSKY. No. I don't think that the latter is necessary at all. I think they are available for any account size. Again, I would say it is largely a question of how the annuity is structured and how it is marketed. This is also in a sense a relative question of how does it compare to other financial products or other insurance products and I think it is comparable.

Ms. RIVERS. Mr. Bodurtha, I have a couple of questions. When you were talking about the MITTS, I understand that it is hard to say where the market is going to be at any given time, but what we have been doing here week after week after week as we look at changing the system is we have looked at projections on yields and we have used projections on yields as the basis for determining whether or not moving to a privatized system is better than having the current system.

What are the yields that somebody can expect with these new kinds of investments?

Mr. BODURTHA. Well, I am not a stock market prognosticator, and I guess one of the fortunate things about protective investments that I am involved in is that they are really contractual commitments. In other words, unlike some other investments where if the stock market goes up——

Ms. RIVERS. But it is a contract just for the investment price, not for a certain return?

Mr. BODURTHA. In other words, it is an investment contract in the sense that if an investor gives us $100 today, it is written in the prospectus that we will owe them, for example, $100 back minimum in 5 years' time, plus 80 percent of whatever the stock market's gain is.

Now, we look to a lot of the historical Ibbotson statistics and things like that to get the sense that stock returns historically can range anywhere between 8 and 12 percent and higher, and if stock market continues to provide those types of returns over the long run, then in my example we are committing to provide sort of 80 percent of that

return.

Ms. RIVERS. One of the things you said is that return is subject to Merrill Lynch's ability to pay.

Mr. BODURTHA. Yes.

Ms. RIVERS. What would affect Merrill Lynch's ability to pay?

Mr. BODURTHA. Really just general creditworthiness of the firm so all the way from Merrill Lynch's basic health of the business, profitability and the like. As long as Merrill Lynch is run well and rated well and so forth, it should have the ability to pay.

Ms. RIVERS. When you made the analogy of—you made an analogy to insurance companies. Insurance companies do well paying out occasional claims. They get in big trouble if there is a hurricane or earthquake or some sort of major disruption. Merrill Lynch is not underwritten by the FDIC. It is their basic creditworthiness. How would they handle a big disruption in the system?

Mr. BODURTHA. Well, interestingly enough, over the term, I think it is a fair question to sort of ask this in sort of what are the overall implications for Merrill Lynch and so forth. The answer really is we have—we have seen some pretty volatile markets over the life of this type of investment already and so, for example, when emerging markets last fall were a bit roiled, the U.S. equity market was quite strong. Merrill Lynch has lots of other businesses in bonds. Its business is globally diversified. So we have already had a chance to see over the last 7 years and experience some volatile times on how this product will perform in those occasions.

Let me also add that there are a variety of issuers out there and just like today when people buy a triple A rated bond or buy a government bond whether it is issued by the United States or some other sovereign entity, it is really important that they understand that they are relying on the creditworthiness of that entity and so the technology or the capability of this—that this type of investment represents is important for people to know about regardless of whether they think Merrill Lynch is a good risk at any given time.

Ms. RIVERS. We had a debate here last week about whether or not the U.S. government was a good credit risk and essentially spent quite a lot of time debating the time frame from 2013 to 2034.

Do you think Merrill Lynch is a better credit risk than the United States Government?

Mr. BODURTHA. No, I wouldn't say that.

Ms. RIVERS. Thank you. Thank you, Mr. Chairman.

Chairman SMITH. If we would give you the ability to tax, would you think it would be helpful. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman. This is really a fascinating committee to serve on with the Chairman. The issues that we are dealing with are probably one of the most profound issues that we have before our Nation today and how to somehow preserve a retirement for those who have been paying into it and felt they were going to get it for years but yet, as we know looking at the facts, around the year 2014, we begin running out of money.

I can't think of any issue that is more important to our Nation as a whole than the one that we are dealing with. A question for you, if I could, Mr. Glassman. I am a long time admirer of yours. I appreciate your candor in your articles that you write, editorials and others. Putting on our pragmatic hat, and not to imply that is not always on, but knowing what we are dealing with, somehow this third rail of somehow changing the chemistry or the makeup of Social Security in a way that any of us are still in office after we do so.

We hear a lot on what has been proposed of a guarantee, of a basic guarantee. At least guaranteeing what those in Social Security are receiving now, which isn't a lot, which really is a piddly little when you look at it for what they were putting into it, but somehow transferring over into something else that would be actuarially sound somehow, that would be the goal of everyone, I am sure.

I guess the question is, can we do that. But my question to you would be should government guarantee personal accounts, somehow guarantee it at the level that they would be receiving from Social Security to begin so, and if so, what kind of guarantee should be offered.

Mr. GLASSMAN. Should government guarantee personal accounts? No. Should government provide a kind of a cushion or let's say a mini-Social Security kind of cushion that would either be determined by income or just everybody gets the same as it works in Britain now? I think that is a good idea. If you guarantee personal accounts, it creates an enormous problem that Mr. Warshawsky, Dr. Warshawsky, referred to in a different context called moral hazard.

Basically, the people know—if I know that whatever I do in my investing the government is going to back me up, I am going to do some pretty wild things most likely. It is not a particularly good idea. But to have a kind of a safety net retaining a portion of Social Security as it is now, I think that's a reasonable thing to do. I am not necessarily sure I am in favor of it, but I think that would be the way to handle the problem that you bring up.

Mr. HERGER. Any other comments by anyone? OK. I think I have—I think this is a very important point because we see that. I think that we have seen it. We saw it back in the savings and loan when somehow people think that they are going to—can't lose, that there is that tendency to get a little more risky than perhaps you would if you didn't have that guarantee.

Mr. GLASSMAN. Also, Congressman, if I could interrupt, it is a slightly different subject, but I think we saw it to some extent in the crisis in Asia where some banks felt that since the International Monetary Fund and other institutions bailed them out in the past in Mexico, that they would bail them out again in Asia.

These are very serious kinds of problems. We want people, we want investors to be at risk. You can't remove risk from investing. Risk is an important discipline. It makes people invest wisely. If you take that away, people are going to do things which, down the road, will end up costing the Federal Government a lot more money.

Mr. HERGER. That is a good point. This idea of too big to fail, we see a number of examples on that. Again, does anybody wish to make a comment on that? OK.

Thank you very much. I have no further questions, Mr. Chairman.

Chairman SMITH. We will start a second round. Maybe following up, Wally, on how we can devise a safety net. A safety net is politically very popular because if you end up not having anything, then you would be more likely to go on Medicaid or other more desperate welfare programs.

The proposal that we are developing in our bill looking for a safety net, and we haven't got it written yet so I am going to take this opportunity to get your advice and ideas on it, the three of you. Is it reasonable to say that if you are less risky after you hit the age 60 and you reduce your holdings to less than 60 percent in capital investments or stock investments and 40 percent or more in secure investments such as bonds, then you would be entitled to at least 95 percent of what you would otherwise have had.

So we are a little desperate looking for a way to approach what Wally is talking about, some kind of a safety net that doesn't, Mr. Glassman, like you suggest, have such a high guarantee that it makes everybody willing to go into the highest possible, most risky investments but at the same time have some kind of individual discretion. Thoughts, ideas from any of you.

Mr. GLASSMAN. I think it is a real problem, these kind—kinds of details. I am not really sure how to iron them out. I think that for political reasons the safety net is needed.

I also feel very strongly that once the vast majority of Americans become invested prudently in the stock market and in the bond market, that their returns will and the size of their accounts will swamp anything that they would be getting from Social Security, which almost makes this point almost irrelevant. I mean, I don't have the statistics at the tip of my tongue, but it doesn't take much investing over a long period of time, you don't have to take that much money away, to have a nest egg by the time you are 50 that could be turned into an annuity that would produce income far in excess of anything you would get from Social Security.

So I realize that for political reasons you do have to fret over the safety net issue, but I think that we will be at a stage not too long from now that it will be irrelevant. In my opinion, as I said to you earlier, Mr. Chairman, I think one of the best ways to get there is through the current vehicle of tax deferred accounts, through IRAs. If you could expand IRAs or expand 401(k)s to unlimited degree, which I think would be a good idea, and then let people transfer money that they currently pay out to Social Security into those accounts, that may solve a lot of the problems.

Chairman SMITH. The current Social Security offers inflation indexing of benefits. Is there any prospect for the private sector to offer such things, Steve, inflation indexed annuities, or some kind of similar protection?

Mr. BODURTHA. Well, in fact, we have begun that process. I think, frankly, a lot will depend on how the government TIPS program, the inflation index bonds that itself offers, unfolds. One of the MITTS that we offered combines a degree of inflation protection along with participation in the equity market. That has been tried. I won't tell you that it has been tried on a widespread basis, but I guess the point is the private sector does have some ability to adapt and address some of these concerns.

Mr. WARSHAWSKY. Let me also try to answer your question. Currently in the United States there are no, strictly speaking, true inflation indexed annuities. However, in the United Kingdom there are such products.

Of course, in the United Kingdom they have had much more experience with inflation indexed bonds issued both by the Government, the United Kingdom Government, and by private investors. Here in the United States we have much less experience with it. It is a fairly recent program.

So I think theoretically, and more than theoretically, it certainly is technologically possible. Our company, as I mentioned in my testimony, offers an inflation indexed annuity, I should say a variable annuity, which is invested in inflation indexed bonds. So that gives you close to inflation protection, but not 100 percent.

Perhaps, returning to your prior question, I think we also believe at TIAA–CREF that people should be invested, not just in the safest investments but also in investments which give them a possibility of higher returns even in the annuity phase. So TIAA–CREF was the inventor of the variable annuity such that even in the annuity phase, the pay-out phase, people still participate in the stock market's performance. Given, as the statistics which I cited, that people have the possibility, and increasingly so, of living after their retirement 20, 30 years, even beyond there is a lot to be gained by participating in the equity market.

So I think maybe in response to your prior question, I think that is something that should be considered as well.

Chairman SMITH. Representative Rivers.

Ms. RIVERS. Thank you, Mr. Chairman.

Mr. Glassman, you said something that I found interesting. You said once people got invested in the new system, their income would swamp Social Security, their Social Security income. I guess that I would argue that we will have a problem with the cost of moving to a new system swamping the current budget. And we have to get through that before we can get to any new system.

The question that I have is while we look forward to those optimistic post-transition plans, how do we get there? How do we deal with the unfunded liability that exists with Social Security today before we can go to a new system for the next generation?

Mr. GLASSMAN. There is no doubt, Congresswoman, that it is a major problem. I don't think that keeping a system which has enormous deficiencies simply because it costs something in the transition stage is a good reason to keep it.

It is true of almost every Federal program. It was true, for example, of the Freedom to Farm Act, that if you want to make a change and there are people benefiting from the current system, then unfortunately you have to lay out a lot of money in order to—buy them off is not a good term, but to effect that transition.

In the long-term, it is going to be better for every one. I absolutely would not deny that it is expensive. Well, it appears to be expensive, at any rate. But you said it exactly right in your question. There is an unfunded and actually unrecognized liability under the current system.

Some people have said, well, let's just make it transparent. Let's actually issue bonds. We have this liability, let's turn it into something that is real and tangible. As you know, there have been lots of proposals including one from my colleague at the American Enterprise Institute, Carolyn Weaver, who was part of the Social Security Advisory Council that offered a plan that involves slightly higher taxes. It is going to cost something.

Ms. RIVERS. Do you think it is fair for—some people have argued that the only way to actually compare plans to the existing situation is to include in the new system the unfunded liability. In other words, it is not reasonable to say that the new system starts on

Tuesday as if nothing has ever happened before, and the only way to make a comparison in terms of what works or doesn't work or what is a good plan is to look at the new system and the old system along with whatever transition plan that has to deal with the unfunded liability.

Mr. GLASSMAN. I think that is perfectly reasonable. I would also say that the current system, the unfunded liability is in the current system, it is not in the new system. There is this multi-trillion dollar liability that the Federal Government has. We have to make that transparent and, yes, I agree with what you just said.

I do think though that in the long run it will be better not just in returns. I think there are other reasons that it is better for Americans to be able to participate in this growing economy.

Ms. RIVERS. So you think that the costs would be worth it?

Mr. GLASSMAN. Absolutely.

Ms. RIVERS. Even if that meant raising taxes?

Mr. GLASSMAN. Yes.

Ms. RIVERS. Mr. Warshawsky, I have a question for you that goes back to the annuities. Social Security currently provides survivors benefits which are equivalent to $300,000 in life insurance. In survivors benefits and disability, to some extent, even out across the differences in race in gender, et cetera, the differences in life expectancies. Should the annuities, if we go to a new system based on annuities, should they have some sort of provision to be fair with respect to sex and race?

Should we consider that because, in fact, our current system does in a different way by the benefits it provides.

Mr. WARSHAWSKY. I think I see the gist of your question. I actually gave some testimony to the Senate Aging Committee in February on women's issues in Social Security reform.

There the tenor of what the session was about and the answers that I addressed to that question is that I think a reasonable model for how this might be handled, vis-a-vis gender is what is required currently in the pension framework, which is that pricing for annuities be on a unisex basis. And that would strike me as to be somewhat comparable to what is done in Social Security.

Ms. RIVERS. The last question that I have for anyone interested in answering it, is we were talking about a safety net. But the safety net currently is not just Social Security benefits upon retirement, it is disability if one becomes injured during their preretirement years, survivor's benefit if one dies.

If we are looking at survivor's benefits, disability benefits, mini-Social Security if that is what we are going to call it, how much is that going to cost? Again, arithmetically, what are you left to invest? I guess that I am trying to put this whole package together. Low-risk investment plus survivors benefits plus disability plus some sort of Social Security guarantee, does that add up to more costs than we have now?

Mr. GLASSMAN. In all of the analyses that I have seen and ever written about regarding reforming Social Security, any careful analyst looks only at the portion of payroll taxes that involve the retirement portion of Social Security. Sloppy people may do the other, but——

Ms. RIVERS. There are a lot of sloppy people on Capitol Hill.

Mr. GLASSMAN. Life insurance, survivorship benefits, and disability seem to me to be separate issues. I can tell you I personally feel that those things would be better left to the private sector.

If you are talking about a life insurance policy that someone buys when he or she first goes to work, which is the way it works with Social Security, I don't think that it would be very hard to construct a life insurance policy where you wouldn't have to make very much in the way of premium payments. To pay them over 40 or 50 years, that is a pretty nice life insurance policy. I don't think that anybody is really hot on making those changes right now.

Ms. RIVERS. Thank you. Thank you, Mr. Chairman.

Chairman SMITH. I would like to mention, Lynn, that out of the seven Social Security proposals that the Ways and Means reviewed last Wednesday, none of them go into that amount of the tax that now accommodates the disability and survivor benefit portion.

On annuities, it seems to me that there is some similarity between an annuity and a no-risk investment. Should we consider annuities as part of the investment guidelines? Right now, in my draft legislation, we say that if a person wants to retire at an earlier age and has enough money to buy the kind of annuity so that the annuity, along with what they have already earned on Social Security, can guarantee the rest of the population that they are never going to be starving and without housing or, in other words, have the same kind of benefits that Social Security would return, then they can buy that annuity to help retire at an earlier age even if they want to retire at 50, 55, or 59 or whatever.

Should we consider annuities as part of an investment portfolio in addition to other investments, and then that brings the question, what kind of returns do we traditionally expect on annuities?

Mr. WARSHAWSKY. I think there are sort of two issues here which are being combined. One is the focus on an annuity as a form of a payment for life, guaranteed for life. But the payments themselves don't necessarily have to be guaranteed.

As I indicated before, that you can have such a thing as a variable annuity where the payments reflect the underlying investment, such as the stock market, and therefore they can vary over time. But the payments continue for the remainder of the life of the policyholder or the participant in the plan. So when I am speaking about annuities, I am really referring to the lifetime guarantee as opposed to the guarantee of any return. There are also annuities which are fixed annuities which do involve the guarantee of a return based on the guarantee of the insurance company that is underwriting the annuity. That is an alternative investment as well. It is more conservative, the returns are lower, but they are guaranteed by the insurance company.

Chairman SMITH. So roughly, if you are looking at a fixed annuity or variable annuity or a guarantee no-loss provision under the programs that Merrill Lynch has developed compared to an indexed 500, what kind of returns you are looking at. Maybe, Steve, starting with you in terms of your low risk portfolio.

Mr. BODURTHA. Well, this will change depending on market conditions. I would be pleased and would actually like to supply some follow-up information on what has actually happened with some of these investments over their life. But in light of the cost of the downside protection, investors should expect to get something less than the index return and maybe that is going to be something along the lines of today's marketplace of 80 to 90 percent. In other words, if the stock market appreciates by a certain amount that investor, through protected investments, might be able to participate 80 to 90 percent of that with no risk of loss of principal.

Chairman SMITH. Dr. Warshawsky, what about a fixed annuity?

Mr. WARSHAWSKY. I will quote, our own fixed annuities are in the 6 percent range currently in current market conditions.

Chairman SMITH. Steve, is there any limit to how much of these secure investments can be offered by Merrill Lynch? Could they be offered to a substantial part of the Social Security population?

Mr. BODURTHA. Excellent question. I think, like the Government's own program with the TIPS, the inflation index, Treasury notes, this is still a pretty youthful market. It is good to know that there is more than one vendor, and my comments aren't to sort of suggest that Merrill Lynch should be the only provider for this type of a program.

So there are multiple providers, somewhere between 10 and 20 on a global basis, I would say that are large scale global institutions. Together I think they could provide a significant amount of volume of this product. But it is something that would need to be coached along as well through interaction with the government.

Chairman SMITH. Here again, I just heard of these in the last 6 months. Did I understand you to say they have been there for the last 5 years?

Mr. BODURTHA. Seven years.

Chairman SMITH. So is the aggressiveness of your marketing sort of waiting to get more experience so you can decide just how far you can expand?

Mr. BODURTHA. I would say with the roaring bull market, people are doing well with conventional stocks and mutual funds and things likes like that. We really see this as a problem solving tool.

When investors, if investors can stomach the risk and the full downside risk of stocks, then it is quite possible they should be fully invested in stocks, as Jim has discussed. However, we find that some investors, some of our clients need to have equity market exposure to reach their long-term goals, but that is not what they are practicing. The reason they are not practicing that is the fear of downside risk and that is when we introduce the product.

Chairman SMITH. Let me finish up with one last question. If part of our goal has got to be a secure retirement, then part of the goal has to be to have a strong enough economy in this country in future years so that the pie that we are dividing up is big enough to accommodate the needs of the workforce and the retirees who they must support. To spur growth, I think it is just so important to have informed investors.

We should allow money to go where individuals presume are the best possible companies so that those companies get that investment money and they put it into research and they put it into the purchase of tools, equipment, facilities that are going to increase their efficiency of production, their productivity, their competitiveness. One issue as we significantly expand investment opportunities, possibly through Social Security reform, is that the more flexibility there is for individuals to choose investments, I would think, Mr. Glassman, the greater chance that the money is going to go into those areas that are most likely to help us get that bigger pie in the future.

Mr. GLASSMAN. Mr. Chairman, I completely agree with you. I think it is one of the problems with some of the discussions of using only index funds for investment, as I have heard in other venues. That if you, for example, restrict or somehow overly encourage investments only in, let's say, Standard & Poor's 500 index type funds or MITTS, that leaves 6,700 other listed companies that won't be getting any money, that won't be getting those investment dollars. I think that investment dollars flow to their best uses when people have a broad array of choices. I think that that is what we should aim for.

Chairman SMITH. Mr. Bodurtha.

Mr. BODURTHA. I just come back to my comment earlier, which is to say I think it is hard if you are going to elect to go down this road to evaluate on the basis of merit some investments over others.

I think there is a tradition in the private sector and the public sector with the administration of public pension funds for establishing minimum standards of investment suitability. Creditworthiness, liquidity, and other standards should be the guide posts if Congress elects to go down that road.

Chairman SMITH. I am going to ask you, Mr. Warshawsky, then I am going to ask for each of you to make a closing statement of anything that we should be considering. Dr. Warshawsky.

Mr. WARSHAWSKY. In response to your question, it is certainly—everything that you have indicated is certainly true. There are, however, a couple of other considerations. Certainly, in terms of individual accounts, private accounts, there would be a consideration of the administrative costs that would be involved in setting up such a system which could, depending on how that is organized and depending on a lot of details, which could eat up some of that benefit which you have indicated.

The other consideration which was inclusive in your question is that that is under the assumption that people will understand what it is that they are investing in and can evaluate its appropriateness. That requires some education. So that is yet another consideration as well.

Finally, I would say that it is not like in comparison to other countries where these individual accounts have been set up where they are basically starting from scratch. It is really a phenomenal boost to those economies to get those accounts going because it introduces markets which they have never had before. This is certainly the experience in Eastern Europe. Here in the United States, we are far from starting from scratch. So I think that some of what the benefits that you have indicated are already there. So it is a matter of a lot of trade-offs, and a matter of degree.

Chairman SMITH. Wrap up summaries, any comments, Mr. Glassman first.

Mr. GLASSMAN. Yes. I think that one idea that I hope people take from this hearing is that vehicles currently exist that limit the downside for investors. They don't completely erase it, but they limit it in ways that I think make people feel much more comfortable about investing in stocks, which is what they have to do in order to get the kinds of returns that would be a good deal higher than those in Social Security.

Let me also comment on what Dr. Warshawsky just said about not starting from scratch. It is true in the United States if we move to a private, partially privatized system of Social Security, we are not starting from scratch. We might not get the same kind of economic boost that other countries have gotten. But there are good things about not starting from scratch.

One is that we have a structure of 3,000 equity mutual funds around. We have things like MITTS. We have people who are certainly not completely educated in investments, but they are more educated than they were, let's say, in Chile in the beginning of the 1980's.

The other thing is not all Americans are participating in the stock market. Right now at this point it is roughly 50 percent. That is the thing that irks me the most, that so many Americans have not been able to participate in the growing American economy the way that rich people have and the way that a great extent that the older people have. The young and the not well-off have not participated, and it is partly because payroll taxes are so high.

They don't have any money to save. That is why I think we should start moving in this direction that we have been discussing today. Thank you.

Chairman SMITH. Steve.

Mr. BODURTHA. I would just like to close by giving some perspective, that I don't view this issue as being one of choosing between a path that is 100 percent risky or 100 percent safe.

The point of my testimony is simply to let you know that rather than sort of accepting the Merrill Lynch product somehow is lock, stock, and barrel as an appropriate prescription for your work, I simply want to point out that this type of thing is possible.

And it is possible to combine some pursuit of growth while limiting of risk. Whether you choose to accept the Merrill Lynch formula for delivering that, the point is the financial markets have the capability to do some of the ability to do the heavy lifting here, to do some of the work which we all want to see done here.

Mr. WARSHAWSKY. Just sort of follow-up to this most recent discussion that we are now having, I think there are a lot of ways of providing increased opportunities for all Americans to participate in the financial markets and to secure their retirement income security.

Certainly, reforms in Social Security are one approach, but then there are also other approaches which include widening the availability of individual retirement accounts and a pension reform proposal which would widen pension coverage which are, again, built on current systems that we have in place but perhaps to make them more widely available.

I think when Congress is considering Social Security reform, I think it is very important that it should be considered in a broader context of pension reform, individual private savings vehicles, and then, hopefully, the balances, the necessary balances and tradeoffs can be considered in that framework.

Chairman SMITH. Very good. Gentlemen, thank you very, very much for contributing your time and thought today. We appreciate it. If you have any other ideas, please let us know. If we have other questions, then you might expect a letter in the mail. But for now thank you very much, and the Task Force is adjourned.

[Additional resource on Social Security privatization submitted by the Budget Committee minority staff follows:]

INTERNET LINK TO NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER, "THE COSTS OF ANNUITIZING RETIREMENT PAYOUTS FROM INDIVIDUAL ACCOUNTS"

http://nberws.nber.org/papers/w6918

[Whereupon, at 1:43 p.m., the Task Force was adjourned.]

The Social Security Disability Program

TUESDAY, JUNE 22, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12:10 p.m. in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Present: Representatives Smith, Toomey, Rivers, Bentsen, and Holt.

Chairman SMITH. The Budget Committee Task Force on Social Security will come to order.

We will proceed with my statement. Representative Rivers, if she would like to make a statement, also any of the other members that would like to put a statement into the record, without objection that statement will go into the record.

Let me say that I think today's meeting on Social Security disability program is important. DI is too often overlooked as we develop modifications to Social Security.

In 1965, 1 million workers were collecting disability benefits. Last year, in 1998, 6 million workers and family members received $49 billion. So it went from 1 million workers to 4.4 million workers in 1998, plus another 1.6 million that were family members of those disabled in 1998.

Social Security disability benefits are becoming a more significant part of the cost of Social Security. Reforms that restore solvency to Social Security are especially important for the disability program, because we have less time before the disability trust fund reaches insolvency. The estimates are that by 2010, program expenses will exceed receipts. By 2020, Social Security projects that 11 million people will be receiving disability benefits. Even if all that has been borrowed from that trust fund is paid back, the disability trust fund will be depleted at that time.

It was interesting that Federal Reserve Chairman Alan Greenspan has told this Task Force that the main reason that the actuarial estimates of the 1983 changes that were costed out to keep Social Security solvent for the next 75 years were wrong is the increased number of people that have gone on disability. The actual numbers are way beyond what they projected in 1983.

The Social Security reform proposals presented to the Ways and Means Committee 2 weeks ago do not privatize the disability insurance program.

Lynn, I was just saying of all the 8 proposals that were before the Ways and Means Committee 2 weeks ago, none of them touched the disability insurance portion of the Social Security program. I have asked today's speakers to help us understand the details of the disability program. This way, Congress can design reforms that keep the disability program strong and protect its beneficiaries.

Would you have a comment?

Ms. RIVERS. Only to thank the members of the panel for being here today. I agree with Mr. Smith, that this is an often overlooked, but very important part of Social Security protections here in this country. I am very interested in hearing what you have to say.

Chairman SMITH. The Social Security Administration has two representatives to discuss the Social Security disability program, Jane Ross, the Deputy Commissioner for Policy, and Mark Nadel. Mark, is that the right pronunciation? He is Associate Commissioner for Disability and Income Assistance. Marty Ford is Assistant Director of Governmental Affairs for ArcUS and speaking on behalf of the Consortium for Citizens With Disabilities.

Ms. Ford, if you would proceed first.

STATEMENT OF MARTY FORD, ASSISTANT DIRECTOR OF GOVERNMENTAL AFFAIRS FOR ARCUS, ON BEHALF OF THE CONSORTIUM FOR CITIZENS WITH DISABILITIES

Ms. FORD. Chairman Smith and members of the Task Force, thank you for this opportunity to discuss the Social Security System solvency issues from the perspective of people with disabilities.

We believe that the title II Old Age, Survivors and Disability Insurance programs are insurance programs, not investment programs, designed to reduce risk from certain specific or potential life events for the individual.

They insure against poverty in retirement years, they insure against disability limiting a person's ability to work, and they insure dependents and survivors of workers who become disabled, retire or die.

In fact, more than one-third of all Social Security benefit payments are made to 6.7 million people who are non-retirees.

People with disabilities benefit from the title II trust funds under several categories of assistance. Those categories include disabled workers, (and I think that these are probably the folks that people most often think about in terms of disability insurance); disabled workers whose benefits are based on their own work histories, as well as their dependent families; retirees who are disabled and whose benefits are based on their own work histories; and I would like to point out two other categories: Adult disabled children who are dependents of disabled workers or retirees, and adult disabled children who are survivors of deceased workers or retirees.

People with disabilities cannot easily be separated out of any portion of title II. For instance, adult disabled children receive benefits from the retirement and survivors programs based on the work history of their parents.

The definition of disability is uniform across these programs and across the country. Administration of the programs includes determination of disability eligibility under rigorous standards, due process and opportunity for appeals up to the Federal courts.

The nature of the OASDI programs as insurance against poverty is essential to the protection of people with disabilities. The programs provide benefits to multiple beneficiaries across generations under coverage earned by a single wage earner's contributions.

Partially or fully privatizing the Social Security trust funds would shift the risks that are currently insured against in title II from the Federal Government back to the individual. Plans which spend the current or projected Social Security trust funds on building private accounts would be devastating for people with disabilities, and we oppose them.

We believe that Social Security is a system that works. We believe that Congress should only consider legislation that maintains the basic structure of the current system based on workers' payroll taxes, preserves the social insurance programs of disability, survivors, and retirement, guarantees benefits with inflation adjustments, and preserves the Social Security trust funds to meet the needs of current and future beneficiaries.

Certainly changes are necessary within the basic structure to bring the trust funds into long-term solvency. However, those changes need not and must not be so drastic as to undermine or dismantle the basic structure of the program. Many privatization proposals try to address the very high transition costs associated with privatization through deep cuts in the current program. In addition, although many solvency proposals claim to leave disability benefits untouched, they actually include elements that will hurt those with disabilities.

Proposals that claim to offset cuts by the creation of individual accounts ignore the fact that many people with disabilities are significantly limited in their ability to contribute to those accounts for themselves or their families.

In my full testimony, which I would hope will be entered into the record, I have highlighted some basic components of the major proposals that could have a negative impact on people with disabilities. These are provided in order to assist in understanding how people with disabilities could be affected by the various proposals. They include things such as: First, the potential impact of changes to the benefit formula because disability benefits are also based on the primary insurance amount and any change to that formula would also affect the disability program.

Second, access to retirement accounts—under many proposals, disabled workers under age 62 would not have access to their individual retirement accounts. Third, issues of privatization of retirement and survivors only and the use of annuities which may seriously affect people who are adult disabled children and need to depend on their parents' work history and earnings, perhaps well beyond their parents' lifetime.

The impact of these and other components must be judged in combination with all other components of any plan under discussion. To that end, we urge the Task Force to follow through on a suggestion made at a Ways and Means Committee hearing earlier this year to request a beneficiary impact statement from the Social

Security Administration on every major proposal or component of a proposal under serious consideration.

We believe that in a program with such impact on millions of people of all ages, it is simply not enough to address only the budgetary impact of change, but also the people impact of change must be studied.

Thank you very much for considering our viewpoints. We look forward to working with you.

[The prepared statement of Ms. Ford follows:]

PREPARED STATEMENT OF MARTY FORD, ASSISTANT DIRECTOR OF GOVERNMENTAL AFFAIRS FOR ARCUS, ON BEHALF OF THE CONSORTIUM FOR CITIZENS WITH DISABILITIES

Chairman Smith and members of the Task Force, thank you for this opportunity to discuss the Social Security system solvency issues from the perspective of people with disabilities.

I am Marty Ford, Assistant Director for Governmental Affairs of The Arc of the United States, a national organization on mental retardation. I am here today in my capacity as a co-chair of the Social Security Task Force of the Consortium for Citizens with Disabilities.

The Consortium for Citizens with Disabilities is a working coalition of national consumer, advocacy, provider, and professional organizations working together with and on behalf of the 54 million children and adults with disabilities and their families living in the United States. The CCD Task Force on Social Security focuses on disability policy issues and concerns in the Supplemental Security Income program and the disability programs in the Old Age, Survivors, and Retirement programs.

For more than 60 years, the Social Security program has been an extremely successful domestic government program, providing economic protections for people of all ages. It works because it speaks to a universal need to address family uncertainties brought on by death, disability, and old age. The Social Security system has evolved to meet the changing needs of our society and will have to change again in order to meet changing circumstances in the future. However, any changes must preserve and strengthen the principles underlying the program: universality, shared risk, protection against poverty, entitlement, guaranteed benefits, and coverage to multiple beneficiaries across generations.

PEOPLE WITH DISABILITIES HAVE A STAKE IN SOCIAL SECURITY REFORM

The Title II Old Age, Survivors, and Disability Insurance (OASDI) programs are insurance programs designed to reduce risk from certain specific or potential life events for the individual. They insure against poverty in retirement years; they insure against disability limiting a person's ability to work; and they insure dependents and survivors of workers who become disabled, retire, or die by providing a basic safety net. While retirement years can be anticipated, disability can affect any individual and family unexpectedly at any time. According to the Social Security Administration, a twenty-year-old today has a 1 in 6 chance of dying before reaching retirement age and a 3 in 10 chance of becoming disabled before reaching retirement age.

People with disabilities benefit from the Title II trust funds under several categories of assistance. Those categories include: disabled workers, based on their own work histories, and their families; retirees with benefits based on their own work histories; adult disabled children who are dependents of disabled workers and retirees; adult disabled children who are survivors of deceased workers or retirees; and disabled widow(er)s.

More than one-third of all Social Security benefit payments are made to 16.7 million people who are non-retirees, including almost 4.7 million disabled workers, nearly 1.5 million children of disabled workers, about 190,000 spouses of disabled workers, and 713,000 adult disabled children covered by the survivors, retirement, and disability programs. Other non-retirees include non-disabled survivors and dependents. For the average wage earner with a family, Social Security insurance benefits are equivalent to a $300,000 life insurance policy or a $200,000 disability insurance policy.

Beneficiaries with disabilities depend on Social Security for a significant proportion of their income. Data from the Census Bureau's Current Population Survey indicates that, in 1994, the poverty rate for working age adults with disabilities was

30 percent. The recently conducted National Organization on Disability—Harris Poll revealed significant data on employment of people with disabilities: 71 percent of working age people with disabilities are not employed, as compared to 21 percent of the non-disabled population. The capacity of beneficiaries with disabilities to work and to save for the future and the reality of their higher rates of poverty must be taken into consideration in any efforts to change the Title II programs.

I. Maintaining Old Age, Survivors, and Disability Insurance as Insurance Programs

The nature of the OASDI programs as insurance against poverty (for survivors; during retirement; or due to disability) is essential to the protection of people with disabilities. The programs are unique in providing benefits to multiple beneficiaries and across multiple generations under coverage earned by a single wage earner's contributions. Proposals that partially or fully eliminate the current sharing of risk through social insurance and replace it with the risks of private investment will be harmful to people with disabilities who must rely on the OASDI programs for life's essentials, such as food, clothing, and shelter, with nothing remaining at the end of the month for savings and other items many Americans take for granted.

Privatization of the Social Security trust funds would shift the risks that are currently insured against in Title II from the Federal Government back to the individual. This could have a devastating impact on people with disabilities and their families as they try to plan for the future. The basic safety nets of retirement, survivors, and disability insurance would be substantially limited and individuals, including those with limited decision-making capacity, would be at the mercy of fluctuations in the financial markets. In this document, the use of the term privatization does not include the proposals for the Federal Government to invest a portion of the trust funds in the private market. Those proposals contemplate shared investment with no shift of the risks from the government to the individual.

In addition, solvency plans which are likely to produce substantial pressure on the rest of the Federal budget in the future could have negative impact on people with disabilities, ultimately reducing the other services and supports upon which they also must rely. Plans which spend the current or projected Social Security trust fund surpluses on building private accounts would have such negative results. Plans which create private accounts from non-Social Security surpluses, though promising, must be weighed against other priorities, such as preserving Medicare.

In short, we believe that Congress should only consider legislation that maintains the basic structure of the current system based on workers' payroll taxes; preserves the social insurance disability, survivors, and retirement programs; guarantees benefits with inflation adjustments; and preserves the Social Security trust funds to meet the needs of current and future beneficiaries. Certainly, changes will be necessary within the basic structure to bring the trust funds into long-term solvency. However, those changes must not be so drastic as to undermine or dismantle the basic structure of the program.

II. Effects of Proposals to Privatize and to Pay for Privatization

Many proposals try to address the very high transition costs associated with privatization through deeper cuts in the current program; these cuts could negatively affect people with disabilities. In addition, many solvency proposals claim to leave disability benefits untouched. However, as described below, these plans include elements that will seriously hurt those with disabilities. Further, proposals that claim to offset cuts in the basic safety net by the creation of individual accounts based on wages ignore the fact that many people with disabilities are significantly limited in their ability to contribute to those accounts for themselves and their families.

Following are some basic components of the major proposals that could have a negative impact on people with disabilities. While some proposals may have been modified for introduction in this Congress, the various components are still "on the table" for discussion. These must be critically analyzed since the combined effects of the provisions may push many people with disabilities and their families into or further into poverty.

Changes to the Benefit Formula—A common element in several reform plans is a modification to the benefit formula so that the Primary Insurance Amount (PIA) is lower. This change also would cut disability benefits since they, like retirement benefits, are based on the PIA. Such a modification would reduce disability benefits from 8 to 45 percent or more, depending on the plan, with some of the major proposals resulting in cuts of 24 to 30 percent. Reducing the PIA would force more people with disabilities further into poverty.

Access to Retirement Accounts—Under many plans, disabled workers younger than age 62 would not have access to their individual investment account to offset the cuts created by changes to the benefit formula. About 85 percent of disabled workers are below age 62 and would have to make up for lower disability benefits with their own resources, which may be limited, until age 62. In addition, those adult disabled children who are substantially unable to earn a living or save for retirement, or those workers who are disabled early in their work years, could have no individual retirement account to access, even if allowed, and could have little to no personal assets to supplement benefits.

Conversions from Disability to Retirement/Adequacy of Accounts—Upon reaching normal retirement age, disabled workers (DI program) convert from disability to retirement benefits. At this point, disabled workers could find their individual accounts are inadequate because the proceeds from individual accounts would necessarily be limited by the fact that, while disabled and not working, no additional contributions could have been made. If the disabled worker were able to work, earnings would likely be lower than average. Therefore, the disabled worker would have far less accrued (in both principal and investment return) than had s/he been able to contribute throughout their normal working years or been able to contribute at higher rates due to higher earnings. Yet, Social Security benefits also would have been reduced due to changes in the benefit formula. In addition, there would be a substantial number of adult disabled children who would have no accounts or minimal accounts at retirement age.

In addition, for each worker, there would be only one individual account. Now, Social Security will pay benefits to spouses, children, adult disabled children, surviving spouses, and former spouses. Under individual account proposals, those accounts would have to be divided among, or may be unavailable to, those who can now get benefits.

Computation of Years of Work—The proposals to extend the computation period for retirees could hurt those people with disabilities whose condition or illness forces a reduction in work effort (with resulting lower earnings) in the years prior to eligibility for disability benefits. These proposals would increase the number of years of earnings that are taken into account in deciding the individual's benefit amount. Essentially, the number of years of "low" or "no" earnings that are now dropped in the computation would be reduced; thus, the years of low and no earnings that people with disabilities may experience prior to eligibility for disability benefits would have a more substantial effect on the individual's average earnings when computing their retirement benefits.

Maintaining the Purchasing Power of Benefits—Social Security benefits are adjusted for inflation so that the value of the benefit is not eroded over time. Some proposals would reduce annual cost-of-living adjustments (COLAs) by arbitrary amounts. These arbitrary reductions cumulate over time so that a 1-percent reduction in the COLA would result in a 20 percent reduction in benefits after 20 years. For people with disabilities who must rely on benefits from the OASDI system for a substantial period of time, cuts could be devastating. It is critical that benefits be set at meaningful levels to support such individuals and that appropriate COLAs be included to ensure that the purchasing power of the benefit is not reduced over time.

Raising the Normal Retirement Age (NRA)—Raising the normal retirement age could create an incentive for older workers to apply for disability benefits in two ways. (1) If only the NRA is increased, the early retirement age benefit would be reduced to a greater degree than under current law (reflecting the actuarial reduction in benefits based on drawing benefits for a number of years earlier than NRA). Disability benefits, unless similarly reduced, would then become more attractive to older workers. (2) For many of those in hard, manual labor jobs who simply can no longer work at the same level of physical exertion, leaving the workforce before NRA will be necessary. Many would apply for disability benefits. These added pressures on the disability insurance program (to make up for changes in the retirement program) would increase costs and potentially create political pressure for more drastic changes in the disability program based upon its "growth".

Privatization of Retirement and Survivors Only—Some privatization proposals claim they privatize retirement and survivor's protection but leave disability protection alone. There would be no intended direct effect on the disability insurance program. However, the systems are not so easily separable: those adult disabled children who depend upon retirees' dependent benefits or upon survivor's benefits would be directly negatively affected. The private accounts of the parents are unlikely to be adequate to provide basic support to adult disabled children for the rest of their lives, perhaps decades after the parents' deaths (especially if the parents were themselves dependent on the private accounts for any length of time before death) and some plans would require the parents to purchase annuities. Where a deceased worker's funds are required to go to the estate, there is no assurance that, upon distribution of the estate, the adult disabled child would be adequately protected for the future. Where funds are transferred to the worker's surviving spouse's account; again, there may be no protection of the adult disabled child.

Annuities—Where retirees are required to purchase annuities with individual account proceeds (as some plans require), no funds would be available for the surviving adult disabled child when the retiree dies. Again, the adult disabled child may live for decades after the death of the parent; a typical annuity approach makes no plans for these dependents/survivors.

Opting Out of the System—One proposal which allows individuals to opt out of the system would require those who opt out to purchase disability insurance. Whether this insurance would be comparable to the current disability insurance system is unknown; currently, there is no insurance comparable to Social Security disability benefits which includes indexing for inflation and coverage of family members. In addition, as the disability community well knows, disability insurance (or for that matter, health or other insurance) is essentially non-existent for most people who already have disabilities. Also, there is no guarantee of support through this means for dependents or survivors with disabilities.

Flat Retirement Benefit—One proposal would replace the benefit formula with a flat retirement benefit ($410 in 1996 dollars). This plan would provide a disability benefit (based on the primary insurance amount) using the current law formula, but reduced to reflect the age-based reduction applicable to age 65 as the NRA rises. This would lead to a 30 percent reduction when fully phased-in. Without the protection of well-funded private accounts, which people with disabilities are unlikely to have, this reduction would harm beneficiaries in the disability insurance program.

Increased Risk and Capacity to Manage Accounts—The increased risk associated with retirement that depends upon private account earnings is an issue for everyone. In addition, the capacity of an individual to manage these private accounts profitably is similarly an issue for everyone, and involves many factors including education, money management skills, and risk-taking. The risks and management issues become a much more significant concern when considering people with cognitive impairments, such as mental retardation, or mental illness, when the impairment creates substantial barriers to the individual's ability to make wise and profitable decisions over a lifetime. In many cases, the person may be unable to make any financially significant decisions. Privatization removes the shared-risk protection of social insurance and places these individuals at substantial personal risk.

Again, we strongly recommend that Congress only consider legislation that maintains the basic structure of the current system based on workers' payroll taxes; preserves the social insurance disability, survivors, and retirement programs; guarantees benefits with inflation adjustments; and preserves the Social Security trust funds to meet the needs of current and future beneficiaries. Changes necessary to bring the trust funds into long-term solvency must not be so drastic as to undermine or dismantle the basic structure of the program.

To assist the Task Force, and, indeed all parties to the debate, we urge the Task Force to follow through on a suggestion made at an earlier Ways and Means Committee hearing to request a beneficiary impact statement from SSA on every major proposal, or component of a proposal, under serious consideration. In a program with such impact on millions of people of all ages, it is simply not enough to address only the budgetary impact of change; the people impact must also be studied and well understood before any change is initiated. For our constituency, people with disabilities, their very lives depend on such analyses.

Again, I thank the Task Force for considering our viewpoints on these critical issues. People with disabilities and their families will be vitally interested in the Task Force's work; the CCD Task Force on Social Security pledges to work with you to ensure that disability issues remain an important consideration in reform analysis and solution development.

Chairman SMITH. Without objection, the full written testimony of all the witnesses will be entered into the record.

Commissioner Ross.

STATEMENT OF JANE ROSS, DEPUTY COMMISSIONER FOR POLICY, SOCIAL SECURITY ADMINISTRATION; ACCOMPANIED BY MARK NADEL, ASSOCIATE COMMISSIONER FOR DISABILITY AND INCOME ASSISTANCE

Ms. ROSS. Thank you, Mr. Chairman and members of the Task Force, for inviting me to discuss these vital issues about the Social Security disability program. I was asked in particular to compare our DI program with private disability insurance, so I will be proceeding to do that.

The Social Security disability insurance program is truly irreplaceable in American life and the same protection is unlikely to be provided through private insurance at any cost. I would like to briefly describe the coverage that is provided by Social Security. I will be reiterating some of the things Ms. Ford talked about, and then examine the two major responses by the private sector to individuals with disabilities, Workers' Compensation and private long-term disability insurance.

With regard to our program, approximately 150 million workers and their families are covered by Social Security against all kinds of losses, retirement, death, and disability. The importance of this disability protection in particular is understood when you consider that an average 20-year-old stands about a 25 to 30 percent chance of becoming disabled before reaching retirement age, so 25 or 30 percent of the people who begin in the work force will become disabled enough to draw out benefits.

Last year, Social Security paid benefits to almost 5 million severely disabled workers and about 2 million members of their families. The total cash benefits that went to these beneficiaries in 1998 was more than $47 billion. What we need to emphasize about the Social Security disability program is that everyone is covered, there is no underwriting and no exclusions, and only the most severely disabled become a part of our beneficiary population.

These are people with a very limited ability to return to the workplace. We continue to press for ways that we can help them return to the workplace. Nonetheless, this is a group of people that has already been judged incapable of working at any job.

What is the actual cash value of this disability insurance program that we are operating and what does it mean to an individual family?

Well, for a 27-year-old average wage earner with a spouse and two children, the Social Security disability protection is equivalent to about $233,000 as a disability income insurance policy. This means that the worker and his or her family would receive over $1,500 in monthly Social Security benefit payments and these payments would be adjusted for inflation.

Also if the worker is entitled to disability benefits for more than 2 years, he or she becomes eligible for Medicare benefits. As you can appreciate, these medical benefits are invaluable for many disabled individuals, since it is quite difficult and expensive to find health insurance in private markets once you become disabled.

And what about the costs of the program? As you know, the Social Security disability program is financed by a payroll tax of 1.7 percent on covered earnings, half paid by the employer and half by the employee. As I said earlier, these taxes last year paid for more than $47 billion in benefits.

Now let me take just a minute for a brief review of other disability insurance programs, specifically Workers' Compensation and private disability coverage.

Let me begin by telling you that there is very little data on these private programs, either on the costs or the benefits of them. We have tried to pull together what is available, and I will do my best to give you a good explanation.

The Workers' Compensation system is also nearly universal and it is a system for replacing lost wages of workers who become disabled as result of an injury on a job, not as a result of a disease or non-work injuries. Basically this insurance is provided by employers in all 50 states and benefits include a weekly payment until the worker medically recovers to the extent possible.

At some point, if the worker is unable to return to work, then payments are based on the extent of disability and medical insurance is provided.

It is also important to note that Workers' Compensation programs integrate with Social Security if the worker is sufficiently severely disabled for a lengthy period of time and there is a maximum amount of combined benefits, which is 80 percent of predisability earnings.

Then moving from the Workers' Compensation to private disability plans, there are generally two categories of private disability insurance, short-term and long-term plans. Within each category there are many variations, but let me try and give you the overall drift here.

Short-term disability plans generally refer to a formal plan in which benefits begin after sick pay has ended. About a third of full-time American workers have such a plan. These plans usually replace about half to three-quarters of earnings and last for about 6 months.

A somewhat smaller percentage of American workers have employer sponsored long-term disability insurance. However, employees in most arduous jobs, those presumably that would be most in need of such protection, are the least likely to have it.

Long-term employer-sponsored disability plans usually replace about 60 percent of predisability earnings, up to a maximum dollar amount, and these plans also are typically integrated with Social Security and Workers' Compensation, thereby reducing the amounts paid for by the private plan.

Individually purchased insurance plans as opposed to those provided by employers are also available. They tend to be plans that are purchased only by high wage earners or self-employed individuals. So this private long-term disability most times has a broader definition of disability than we have in the Social Security disability insurance program. More likely it is your inability to return to your customary work, and there is a good deal more emphasis on helping people to return to work because of this less severe definition.

One final point I would like to make: Because of the potential adverse selection risk to insurers, the disability income insurance market is heavily underwritten. Persons who are at higher than normal risk of becoming disabled or persons whose income stream is not consistent over time would be deemed unlikely to be insurable by the providers of this private disability insurance. In this environment, it is highly unlikely that a market for private disability insurance would emerge to provide the same kind of universal coverage as we have under the Social Security disability program.

In conclusion, I want to revisit the question I posed at the beginning of my testimony: Can private disability insurance provide the same level of protection to all workers at the same low cost of Social Security disability insurance? It seems very unlikely that the private market could replicate that coverage at similar cost.

Social Security is a mandatory, virtually universal social insurance program. Private insurers are selective, excluding those individuals at higher risk of becoming disabled. A great many people would simply not be able to buy private disability insurance at any price and Social Security returns about 97 percent of the premiums, if you want to call the taxes that, that it takes in, gives 97 percent back to beneficiaries, while private insurers return far less, as little as 45 percent of the premiums they receive.

Private disability insurance can and does serve a valuable purpose today by providing additional financial protection to those who can afford it and who qualify, but only Social Security provides coverage to all workers and their families at a lower cost and greater value than any private insurance now available.

Again, thank you for the opportunity to talk with you today, and I would be happy to answer any questions that members of the Task Force have.

[The prepared statement of Ms. Ross follows:]

PREPARED STATEMENT OF JANE L. ROSS, DEPUTY COMMISSIONER FOR POLICY, SOCIAL SECURITY ADMINISTRATION

Mr. Chairman and members of the Task Force, thank you for inviting me to discuss the Social Security Disability (SSDI) program and whether private insurance, by itself, can provide the same degree of protection to all working Americans at the same low cost. In my statement today, I will outline the scope and purpose of SSDI, and the cost and value of coverage. Then I will discuss the two types of insurance now provided by the private sector to deal with disabilities: first, workers compensation which applies only to disabilities caused by work, and second, private disability plans that apply to any disability.

SOCIAL SECURITY DISABILITY

The Social Security system as a whole operates as a social insurance program. That is, Social Security spreads the cost of protection against the risk of lost income due to retirement, death, or disability over the entire working population, with more protection, per dollar earnings, for lower paid workers and for workers with dependents. Consequently, the value of benefits for any given worker depends on his or her individual circumstances-earnings level, marital status, dependent children, years in the workforce, and age at disability or death. Like Social Security in general, the SSDI program provides an extra measure of protection for lower-wage workers. Due to the progressive nature of the program, the benefits formula replaces a greater percentage of pre-retirement earnings for lower-wage workers than higher-wage workers.

Largely absent from the current public debate is the fact that about one third of Social Security beneficiaries are not retirees or their dependents. They represent severely disabled workers, their children, or the surviving family members of workers who have died. Social Security pays benefits to more than 4.7 million disabled workers, nearly 1.5 million children of disabled workers, and almost 200,000 spouses of disabled workers. Because about 25 to 30 percent of today's 20-year olds will become disabled before retirement, the protection provided by the SSDI program is extremely important. This is especially true for young families often struggling to afford adequate private insurance. For a young, married, average worker with two children, Social Security is the equivalent of a $233,000 disability income insurance policy. In addition, SSDI benefits, like retirement benefits, are adjusted for inflation, so that the value of the benefit is maintained over time. Disabled workers and their dependents received $47.6 billion in cash benefits under the Social Security program in fiscal year 1998.

Furthermore, SSDI benefits are the gateway to the Medicare program to those individuals who have been eligible for disability benefits for 24 months. These benefits provide health care coverage that to many SSDI beneficiaries is simply irreplaceable, since many would not be able to obtain insurance in private markets simply because they are already disabled. The Medicare program paid over $24 billion in benefits in fiscal year 1998 to individuals whose entitlement to Medicare is based on their SSDI benefits. Thus, about $72 billion was paid in fiscal year 1998 from the Social Security and Medicare programs on behalf of disabled workers and their families.

As with the retirement program, SSDI is funded through a payroll tax on covered earnings, paid by employees, their employers, and the self-employed. The current payroll tax on earnings is 0.85 percent for employees and employers, each, and 1.7 percent for the self-employed.

SSDI is designed to protect workers covered under the Social Security program who become severely disabled, and it strives to ensure that applicants are judged on the basis of a uniform set of standards. The criteria we use to award disability benefits requires that the condition either be expected to result in death or last at least 12 months. To qualify, the individual must be unable to perform any substantial work in the national economy because of a medical condition. Thus, the inability to do one's own past work or the inability to find suitable employment are not a sufficient basis for meeting the definition of disability. Additionally, applicants must have worked 20 quarters during the 40 quarter period ending with the quarter in which disability began (special provisions apply for workers who are under age 31), and they must complete a 5-month waiting period after the onset of the disability.

After a claim is taken in one of Social Security's field offices, it is forwarded to one of the State Disability Determination Services. These state employees are responsible for following up on at least 1 year's worth of medical evidence in support of the claim, scheduling consultative examinations if necessary, and making the disability determination at the initial and reconsideration (the first level of appeal of an adverse initial determination) levels. The States are fully reimbursed for making these determinations. The process of evaluating an individual's disability accounts for the administrative costs for the disability program being somewhat higher (3.3 percent of benefits) than those for the retirement and survivor program, largely because of the cost of obtaining medical evidence and the need for a thorough evaluation by a physician or other highly trained professional reviewer.

While the Social Security eligibility criteria are very strict, we also have a very structured system to ensure that applicants' rights are protected and that those applicants who are eligible, actually get their benefits. Currently, a physician must be part of the decision-making team, although we are testing a system where certain claims, generally the most severe and obvious cases, would be decided by a trained layperson. After a reconsideration denial, a claim can be appealed to an administrative law judge, then the Appeals Council and up to a Federal court. We also are testing a model, which would streamline the process by eliminating the reconsideration step.

While the primary purpose of SSDI is to replace a portion of income, the program also includes provisions designed to encourage beneficiaries to return to work. Even when individuals have significant disabilities, with appropriate support and vocational rehabilitation (VR), they may be able to work again. The primary mechanism that is used by Social Security to help people return to work is the referral of beneficiaries to State vocational rehabilitation services. I would like to mention at this time the Administration-proposed legislation in 1997 that called for a Ticket to Independence program that would further our efforts at rehabilitation by introducing the concept of consumer choice in obtaining employment services. Similar legislation overwhelmingly passed in the House in 1998 and has now evolved into the Work Incentives Improvements Act that passed the Senate by a vote of 99 to 0 on June 16, 1999. The President's budget provides full funding support for this legislation.

I would like to turn now to a discussion of the range of workers compensation and private disability benefits available.

WORKERS COMPENSATION

While SSDI covers workers with severe disabilities regardless of how the disability was developed, the workers' compensation (WC) system is designed to provide reimbursement for lost wages and medical expenses for workers who become disabled as a result of an on-the-job injury. WC laws were first enacted in the early 1900's and now separate programs are provided in each of the 50 States and the District of Columbia. Virtually all employers are required to secure their compensation liability either through private insurance, by self-insuring, or by membership in a State fund. Employers who secure their compensation liability are protected from other liability that could arise because of injuries to their employees.

One of the primary goals of an effective WC program is to restore the injured workers to their previous employment, and thus the programs emphasize medical and vocational rehabilitation. Other benefits include weekly payments that are based on the degree of disability sustained as a result of the injury, and such medical care as the nature of the injury or process of recovery may require. Benefit payments totaled $42.6 billion in 1996.

Workers compensation is not a stand-alone system. It is the first payor, but integrates with Social Security. In most States if workers go on the Social Security disability rolls, the Social Security payment is reduced, so that the combined Social Security/workers compensation amounts are limited to 80 percent of pre-disability earnings.

EMPLOYER-PROVIDED PRIVATE DISABILITY INSURANCE

Modern-day Private disability insurance grew up in a climate which climate that already included Social Security and other public benefits such as VR and WC. As a result, these private plans assumed the existence of Social Security and were tailored to integrate with it. There are many different types of private disability insurance plans. While they fall under two general categories, short-term (STD) and long-term (LTD), there are many variations. About two-thirds of long-term plans are employer-sponsored, and about one-third of plans are individually purchased. Further adding to the variety are the differing definitions and provisions within the plans; there is no standard terminology.

DEFINING DISABILITY

The definitions of disability within the types of plans vary to some extent, but they generally share major characteristics. While short-term disability plans have different definitions of disability, they typically include payments for short-term impairments as well as pregnancy. Employer-sponsored long-term disability plans usually have a more lenient definition of disability for the first 2 years, after which the definition becomes more stringent. Generally, the initial definition is the inability to perform the employee's usual occupation. After 2 years, the definition usually requires the employee to be unable to perform any occupation, similar to the Social Security definition. Finally, while there are exceptions, most individually purchased plans define disability as the inability to perform one's usual occupation for the entire benefit period-generally to age 65.

While SSDI benefits are limited to age 65 as well, the individual begins receiving retirement benefits on attainment of age 65, and the conversion from disability to retirement benefits is invisible to the beneficiary.

COVERAGE—WHO AND WHAT IS COVERED

Short-term disability and long-term disability plans serve different purposes and have different provisions. Generally, short-term disability plans refers to a formal plan in which benefits begin after sick play has expired, though benefits but may be in lieu of sick pay. Based on Bureau of Labor Statistics (BLS) data, nearly 4034 percent of full time private sector plus State and local government workers in this country have some type of short-term disability plan..

Short-term disability plans usually replaces from 40-70 percent of earnings, but it can replace earnings entirely. Benefit periods range from 30 days to 6 months, though some plans have terms of up to 24 months. Ninety percent of employees return to work within 8 weeks, often because the impairments covered are not severe, e.g. recovery from pregnancy surgery. Because of the short-term nature of most short-term disability impairments, there is little connection between short-term disability plans and Social Security. Ideally, employer sponsored long-term disability plans begin paying when SDT short-term disability benefits end. The earnings replacement rate for these long-term disability plans is about 60 percent of pre-disability earnings, up to a maximum dollar amount.

Only one third of full-time workers currently have employer-sponsored long-term disability plans.

It is worth noting that employees with the most arduous jobs—those who presumably need the protection the most-are less likely to have long-term disability plans.

Ideally, employer sponsored LTD plans begin paying when SDT benefits end. The earnings replacement rate for these LTD plans is about 60 percent of pre-disability earnings, up to a maximum dollar amount. Based on BLS data, slightly under 1/3 of full-time workers currently have employer-sponsored LTD.

The following chart shows the percentage of employees of state and local government, small private firms (under 100 employees) and medium/large firms with employer sponsored LTD by job type of occupation.

BENEFITS

In contrast with STD, employer-sponsored LTD plans generally are integrated with Social Security and Worker's Compensation. LTD plans are cost driven. Long-term plans are generally oriented toward their net costs.can provide both cash benefits and rehabilitation services. That is they screen their clients beneficiaries with a view toward rehabilitation, and decisions on what benefits to provide often turn on the cost of rehabilitation vs. the cost of benefits, in addition to job availability. Many larger employers use disability management strategies including early intervention and partial or residual benefits to encourage return to work.

In determining cash benefit levels, employer-sponsored LTD long-term disability plans generally usually are integrated with Social Security and Worker's Compensation. These LTD plans are constructed to take into account Social Security. Those employees who meet the Social Security definition of disability are encouraged or required to apply for Social Security benefits. In fact, insurers and employers count on the integration of their of their plans with Social Security; LTD long-term disability benefits are generally offset—reduced—by Social Security benefits.

INDIVIDUALLY PURCHASED DISABILITY INSURANCE

We were unable to obtain data on participation rates for individual Individual disability plans are thought to be a small part of the private market although there is a lack of data on the actual extent of coverage. However, experts believe participation is quite limited because they tend to be very expensive. Participation is mostly limited to highly compensated employees or self-employed individuals. These plans may replace up to 80 percent of earnings, though more typical replacement rates are 60-70 percent. Often, payments of these plans, in contrast to employer-sponsored LTD long-term disability plans, are not reduced by Social Security or other programs.

THE PRIVATE SECTOR DOLLAR COSTS OF COVERAGE

The out of pocket costs of SSDI coverage is a payroll tax of 0.85 percent. Assuming a worker married with 2 children, average earnings since age 22 and onset of disability at age 35, it would take $203,000 of disability insurance to equal payments to the family unit. It is difficult to present meaningful information on the price of private disability insurance because it varies so much by age of customer and variations in size of coverage.

Perhaps the most useful approach in examining the cost of private disability insurance is viewing it in terms of value to the beneficiary. This value can be determined by looking at the proportion of the premium dollar that is returned as benefits to policyholders. We can determine this proportion by looking at the cost structure of companies, although they vary from company to company.

Costs vary from company to company. One major insurer estimated costs as shown on the following chart. It should be noted that claims processing costs are included under benefits and risk management. only 45 cents of every premium dollar is returned to beneficiaries.

Claims processing costs account for about 3 percent of this category.

Clearly it is difficult to compare private and public sector costs since the enterprises are so different. As previously noted, Social Security disability administrative costs are about 3 percent of payroll the disability payroll taxes. It would be tempting to conclude that the private sector costs are similar, since private sector claims processing costs in this example are estimated at 3 percent. But administrative costs are also embedded in other categories, such as acquisitions (which represents items such as underwriting and sales) and customer service (for instance, billing and other policy services). . And the bottom line is that the Social Security system returned 97 percent of the money it takes in to beneficiaries while private firms return far less-as little as 45 percent of the money it takes in.

ACCESS TO PRIVATE INSURANCE COVERAGE

Because of the potential adverse selection risk to insurers, the disability income insurance market is heavily underwritten. Persons who are at higher than normal risk for becoming disabled, or whose income stream is not consistent over time, would likely be deemed uninsurable by the providers of private disability insurance. In this environment, it is highly unlikely that a market for private disability insurance would emerge to provide the same universal coverage available under SSDI.

Even if an individual is able to purchase a policy from a private company in the current market, comprehensive disability insurance is much more expensive than SSDI. SSA has a broader risk pool. If SSA were allowed to exclude individuals from coverage because those individuals had a high likelihood of becoming disabled, as do private companies, SSA's "premiums" would decrease.

CONCLUSION

Private disability insurance serves an important purpose in providing an additional degree of financial security for the minority of the workforce that enjoys coverage. However, Social Security Disability Insurance and private plans serve different purposes However, the operative word is additional. Though Social Security provides nearly universal and portable coverage, only the most severely disabled individuals receive benefits. For those found to be disabled, benefits are also extended to dependents. Only Social Security provides coverage to all workers and their dependents. I would note that 25 million workers lack health insurance. It is hardly likely that employers who now cover about one third of employees with long term disability coverage would provide all workers with disability coverage. Moreover the universal coverage that all workers now have under Social Security is provided at lower cost and greater value than now available on the private market. Assuming a worker married with 2 children, average earnings since age 22 and onset of disability at age 35, it would take $203,000 of disability insurance to equal payments to the family unit. The cost of such coverage varies by insurance company.

Private insurance was built around existing public programs and depends on programs such as Social Security as a way of containing costs. In addition, some larger employers in the private sector provide a range of disability management services including early intervention, rehabilitation and partial benefits where cost effective.

Mr. Chairman, this concludes my remarks. I would be happy to entertain any questions you or the other Task Force Members may have.

SOURCES

In addition to Social Security information and administrative data, we have relied on the following sources of information:

BLS reports on Employee Benefits in State and Local Governments, 1994.

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Owens, Patricia M, Insurance Issues and Trends: A Focus on Disability Management including Rehabilitation, in Private Sector Rehabilitation: Insurance Trends & Issues for the 21st Century, ed. Perlman and Hansen, National Rehabilitation Association, Alexandria, Virginia, 1993.

Workers' Compensation: Benefits, Coverage, and Costs, 1996, National Academy of Social Insurance, March 1999.

Chairman SMITH. Thank you very much. Does the Social Security Administration know why there has been such a significant increase of people going onto disability? We have seen the rate of disability among the total number of covered workers increase 300 percent over the last 30 years. Is the Social Security Administration aware of why that number has grown so rapidly? Not in terms of numbers with the population, but in terms of the rate of the total number covered?

Ms. ROSS. We think there are a variety of reasons for the growth in the program. In the beginning of the 1990's, when there was a substantial increase, a good deal of it was probably related to the fact that we had an economy with very high unemployment. People who are working but have severe disabilities may be fine in an ordinary economy, but if they should lose their job, then it is extremely difficult for them to find another one. So the high unemployment in the early nineties was certainly one of the important features.

There have also been some changes in laws and some court cases which have contributed to the growth of the program. So there is a variety of kinds of things that have happened over time. I will provide more information for the record.

[The information referred to follows:]

The reasons for the growth in the disability program include:

• *Age of disabled workers.* The average age of disabled workers is declining. Younger beneficiaries mean fewer conversions to retirement benefits and fewer deaths (i.e., longer on the DI rolls).

• *Business cycle.* Job losses during recessions encourage individuals to file for disability and discourage those on the rolls from seeking employment. Recent data indicate that a 1-percent increase in the unemployment rate translates into a 4-percent increase in DI applications.

• *Increased participation of women in the workforce.* Increased labor participation by women increases the percentage of the population insured for disability. This increase in the insured population accounted for 9 percent of the overall DI growth between 1988–1992; 19 percent of the growth among women. Although women are less likely to apply for benefits than men are, once they are on the rolls they are less likely to leave.

• *Legislative changes (1984 Disability Amendments).* First, revised criteria for evaluation of mental impairments, pain and subjective symptoms. Added weight given to opinion of treating physician; combined effect of multiple impairments. Second, medical improvements—the standard of review for termination of disability benefits. Third, benefits continued during appeal of termination decision in a disability review.

• *Impact of court decisions.* Federal court decisions on appeals of our disability determinations have often resulted in a more generous interpretation of SSA's regulatory disability standard, and a consequent expansion of the DI rolls.

Chairman SMITH. Mr. Nadel, did you have additional testimony?

Mr. Nadel. No, I do not.

Chairman SMITH. The GAO considers Social Security disability to have a heightened vulnerability to waste, fraud and abuse and mismanagement. Medicare has made significant changes in terms of trying to reduce fraud. Have we moved in that direction in any way with Social Security disability?

Ms. ROSS. One of the important things Social Security has been doing over the past few years to make sure that our program has achieved a high level of integrity is doing continuing disability reviews. That is to say when people are on our rolls, every few years we reexamine them to be sure that they still meet the standards of our disability program. For many years, right through the early nineties, especially when so many people were coming on the rolls, we didn't do nearly as many continuing disability reviews as we ought to have been doing. Now we are working off our backlog, and in a couple of years we will be doing each year just those that need to be conducted that year.

Chairman SMITH. This is a re-medical evaluation, so they would go back to the doctor again?

Ms. ROSS. Yes, sir.

Chairman SMITH. What is happening in that review?

Ms. ROSS. Well, each year we do find some——

Chairman SMITH. What percentage roughly have you decided are capable of doing some work?

Ms. ROSS. This is an evaluation to see if they have medically recovered. My understanding is that of the group of people that we look at, something like about 6 percent of the people we find have recovered or have improved so that they no longer are eligible.

Chairman SMITH. I guess I am not totally sure of the guidelines. Is it that a person has to be incapable of doing any work, or what is the criteria to be eligible for Social Security disability as opposed to workman's comp?

Ms. ROSS. That is a good question. What we say is a person is unable to do any job in the economy because of a medically determinable impairment that is going to last 12 months or longer. So the definition is that you can't do any kind of work to a meaningful degree.

Chairman SMITH. The latest GAO performance and accountability series states only 1 in 500 DI beneficiaries return to work after receiving benefits. GAO recommended that SSA put together emphasis on return to work efforts.

Has this been done? How can we improve the return to work efforts?

Ms. ROSS. Well, first of all, one of the reasons that few people return to work is because our population is severely disabled. But we don't stop there. We think that it is important to see if there are things that we can do to provide incentives for people to try work. The Kennedy-Jeffords bill, which is moving through the Congress right now, has a variety of provisions in it which the administration supports which ought to help with people at least attempting to return to work.

For example, there is a "ticket to independence," which gives people who are disabled a much broader range of vocational rehabilitation options that they can try. That could be very positive. Quite importantly, it provides much more extensive Medicare coverage, because one of the things that disabled people tell us is that one of the reasons they are reluctant to try work is they are afraid they will lose their health insurance and never be able to regain it. These are important things.

Chairman SMITH. Mr. Nadel, your comment, and then Ms. Ford, and then we will move on.

Mr. NADEL. In addition to the legislation, we also have some initiatives under way. For example, we are planning a demonstration project in 10 States to help people with mental illness, particularly with mood disorders, which accounts for about a quarter of the DI roles. The plan there would be to facilitate people getting a full range of treatment, including pharmaceuticals, which they otherwise might not normally be entitled to, so that they would be able to eventually get better, get off the roles and return to work. So there are things in addition to just the waiting for the legislation to be passed.

Chairman SMITH. Ms. Ford, your comments?

Ms. FORD. Yes, I would like to comment on a couple of the questions you just raised. Back on the issue of why there are more people with disabilities, I think one thing to add to what Ms. Ross has said is that medical advances have improved the life expectancy of people with conditions that in the past would have caused an earlier death. That is another reason for the increase in the roles.

The disability community has supported maintaining the integrity of the Social Security System through the use of the continuing disability reviews. We think that such reviews are very important in terms of maintaining the integrity of the program.

In terms of the work incentives bill in the House, H.R. 1180, there is another important aspect of it, too, and that is the beginning of a nationwide—or I should say—a demonstration program that will go on on a fairly large scale to test the usefulness of doing a cash offset for those people who are likely to have low-wage, entry-level jobs that don't carry health insurance. People in that situation must look at both the issue of health care coverage when they go to work and also whether or not they can actually earn enough to sustain themselves, given the level of disability that they are living with. This applies to many of the people I represent through The Arc of the United States, people with mental retardation.

So we are looking also at the demonstration program that will test that cash offset to allow people to have a lower cash benefit as their earnings increase.

Chairman SMITH. Thank you.

Representative Rivers.

Ms. RIVERS. Thank you, Mr. Chairman.

Ms. Ross, I am curious. You don't know if you can answer this question, but one of the discussions that we have had around Social Security is the idea of raising the retirement age to 70 or maybe higher. Is there any likelihood that if we were to do that, we would see an increase in disability claims for people, say, between the ages of 60 and 70?

Ms. ROSS. Yes, there is. As a matter of fact, our actuaries have incorporated that kind of an estimate into their calculation of savings from changing the retirement age. I think our estimate is something like 20 percent of the savings from changing the retirement age would be offset by more people coming onto the disability roles.

People may be willing to hang in there and wait for retirement if they are waiting until 65, but they may not be able to continue to work beyond that time.

Ms. RIVERS. Are all of the costs associated with paying disability payments borne by that designated portion that is collected, or does other Social Security money have to go in to make the pot adequate to meet the needs of all those who have claims?

Ms. ROSS. Right now the 1.7 percent payroll tax is adequate to finance the benefits as well as the administrative costs of operating the disability program. But as the Chairman said earlier, the disability program, as well as the old age and survivor program, is facing financial challenges and will actually run out of money sooner.

Ms. RIVERS. Which brings me to another question that I want to ask Ms. Ford. Given that we know that complicates the issue all the more, Ms. Ford, could you believe for folks who draw on— young people who are disabled and draw against their parents' earnings, do they get enough to live on under Social Security?

Ms. FORD. Well, it depends entirely on what the parents have earned, because, and correct me if I get this wrong, the adult disabled child, first of all, has to have been severely disabled since childhood, and the benefit level that that person receives while the parent is still living, as either disabled or retired, would be 50 percent of the parent's benefits, depending on whether the family maximum affects them in any way. When the parent dies, the adult disabled child would get up to 75 percent of the parent's benefit, again, depending on whether there is a family maximum impact. So it depends entirely on what the parent has earned, and many disabled adult children receive SSI to supplement the Title II benefit as well.

Ms. RIVERS. One of the complaints we get in our office often is for people in their twenties in particular who are drawing Social Security and find that they can't live on it, and it is not a nice message to deliver that we are already having trouble with the system, and the likelihood of benefits going up is not good.

Ms. FORD. That is right. I don't think people with disabilities could afford a reduction in those benefits in any way. With SSI already supplementing many people, it is an indication that the benefits are not high enough. That is one of the reasons why people want to be able to work if they possibly can, and figuring out a way to make it possible to have some income while the individual is working, if possible, and while maintaining a reduced benefit level would help our folks tremendously.

Ms. RIVERS. Ms. Ross, what is the Social Security Administration's plan as we move toward the future and see an increased demand for this, and if, as I mentioned earlier, we see an increase because the age goes up, do we have to look at raising taxes for that portion, that 1.7 has to go up to 1.9 or 2? How is the Social Security system anticipating dealing with that?

Ms. ROSS. Well, as we have talked about solvency overall, we have tried to address disability in addition to old age and survivors. So when the President put forward his proposal about transferring 62 percent of the surplus and investing some of it in the market, and then also looking for some kinds of cuts or benefit changes, we have tried—we are very cognizant we are doing this for the whole OASDI program, we haven't left it out.

Ms. RIVERS. The overall fix speaks to that.

Ms. ROSS. Right.

Ms. RIVERS. Thank you very much.

Chairman SMITH. The gentleman from Pennsylvania, Mr. Pat Toomey.

Mr. TOOMEY. Thank you, Chairman. I just wanted to follow up on a point that you made earlier. In regard to the question, can private disability by itself provide the same degree of protection to all working Americans at the same low cost as SSDI, the answer to that obviously is no, according to your testimony. But it strikes me that the answer is not obviously no.

The next sentence is that if private disability would become a substitute rather than a complement to Social Security, its cost would be prohibitively higher, and not everyone would be allowed access to vital coverage.

Isn't it more accurate to describe the cost to some would be higher, but the cost to others might be lower?

The other question I would have is wouldn't it be accurate to characterize the cost as really consisting of two categories; one is direct benefits that are paid, and the other is the cost of administering those benefits? If you maintained a standard for benefits, it is not obvious to me why a private mechanism might not be able to manage the administration at a lower cost or the same cost.

The last part of this is isn't it fair to say the current cost for SSDI is not really fully reflected in the sense we know we have a looming financial shortfall there, so we haven't really fully accounted for that cost, at least in terms of how we pay for it.

I am just wondering if you could comment on that?

Ms. ROSS. Surely. I have a couple of points, and maybe Mark has a couple of others.

First of all, I want to go back to this business of underwriting. The Social Security System has no rules about who can become a part of our insurance program. Anybody who is a worker and pays their taxes can become a part, regardless of the regularity of your work, and regardless of your previous impairment-related history. That is unlikely to be the case if firms that are in business to make profits, quite appropriately, were involved in this business. There would be simply people who are uninsurable. So I think that is an issue that needs to be worried about.

Then in terms of administrative costs, the Social Security System now runs about 3 percent administrative costs. So 3 percent of our tax dollars are going to run the program, while the information we were able to gather suggested that 45 percent or so of the costs of some private insurance goes to administration because they were dealing not only with actually operating the program, they had other kinds of costs like sales, which are something you would have to do if there were a lot of firms in the private sector.

So I think it is a difference in what is involved in costs in the private sector. You are certainly right that right at the moment the entire Social Security System is looking forward to making sure that we are able to meet the financing challenges. I don't anticipate that the administrative costs would be higher, and we certainly plan to have a system which covers disabled people in about the same way.

Mr. NADEL. If I could add, sir, it is not altogether clear that were you to privatize the entire system, that the costs for people, any group of people, would be lower, because the costs currently reflect that it is an underwritten system, so that the higher risks are already screened out. So in the pricing of the private insurance, their actuarial assumption is based on a pretty good risk pool. So it is true, were you to in some fashion try to substitute private insurance, people would probably end up at the low end paying what they pay now; others would pay considerably more if you made it compulsory. Some people would pay a huge amount more.

But the people that would be paying less are probably paying less right now. But, again, it is conjectural. But the point is the current pricing reflects people who are insurable and are pretty good risks.

Mr. TOOMEY. As a follow-up to that, it strikes me that sometimes we design systems around the exceptions rather than designing a system for the large numbers and then dealing with the exception. So I am just wondering, you mention in a privatized system there might be people who would simply be uninsurable. That may well be the case. Do you have any estimate of what percentage of the work force would be uninsurable and, therefore, need to be dealt with in a separate system?

Ms. ROSS. I don't have any idea how you would come up with the number. I certainly don't have one off the top of my head, but there are people—anybody who already had some sort of disabling condition before they became part of the work force, I would assume they would be if not uninsurable, at least someone who had a very high cost associated with them.

Mr. TOOMEY. It just strikes me there are many kinds of insurance for many kinds of risks, and there are people who are more prone to those risks than others, and, nevertheless, the large majority of people are typically able to acquire the kind of insurance they need. I would suspect the same would apply here.

That is all.

Ms. FORD. Thank you.

The experience of people with disabilities is that once you have a disability, you cannot acquire the insurance. You cannot acquire the disability insurance, and many people cannot acquire appropriate health care insurance because they have what is called a preexisting condition, and they are considered uninsurable by the insurance companies. Families experience this with the birth of a child with a significant disability. Adults experience it if they are uninsured and have an accident of some sort.

Mr. TOOMEY. I am not disputing any of that. I am fully aware of that. I am just wondering what sort of magnitude of percentage of the United States population fits that description?

Ms. FORD. I am not sure, but I go back to at least one-third of the beneficiaries in the Title II programs are not retirees. A significant proportion of those are people with disabilities or their dependents.

Mr. TOOMEY. Thank you.

Chairman SMITH. The gentleman from New Jersey, Mr. Rush Holt.

Mr. HOLT. Thank you, Mr. Chairman. I just want to make sure I understand, Ms. Ross, your claim about the difference in administrative costs between the Federal program and private programs.

In the 3 percent administrative costs that you point to for Social Security disability, is there anything that is not included? I just want to make sure we are comparing apples and apples here when you talk about the 45 percent that some private insurers would charge for this.

Is there any sales or customer service that is included in one that is not included in the other? I realize Social Security you don't have sales costs per se, but you do have the same customer service costs.

Ms. ROSS. That is right.

Mr. HOLT. There is certainly some cost of informing the public that is equivalent to sales costs, although much reduced, of course.

Ms. ROSS. That is all true, and that is incorporated in the 3 percent, which reflects the cost of Social Security employees as well as employees of disability determination services who work in State offices and do our determinations, actual determinations of disabilities. So we are pretty comfortable that this is a very good reflection of the amount of the payroll tax dollar that is going to run the program however you define that.

Mr. HOLT. That is my only question for the moment. Thank you.

Chairman SMITH. We will start a second round. It has been suggested the Americans with Disabilities Act has resulted in more individuals with disabilities being employed, and those individuals have pushed themselves to work and to perform, but usually end up not lasting the 30 or 40 years, but once they get over 10 years, there is a greater number of these individuals that go on disability.

Do we know that to be true, or have we got any statistics on that?

Ms. ROSS. I don't know any documentation of that particular anecdote. The purpose of the two laws is quite different, one is to make sure that you are treated fairly in the workplace and that you are accommodated appropriately. The other is to make sure that you have some income if you can no longer work.

I can logically see how both of those things could happen.

Chairman SMITH. Ms. Ford, it seems to me that to the extent that that might be true, then if they were not on Social Security, they would be on SSI, so the taxpayers in some way are going to have to accommodate the problem.

Ms. FORD. Well, remember that the SSI program uses the exact same definition of disability and all of the rigorous assessments that go with it. So you are dealing essentially with the same level of impairment in the person, whether you are dealing with the Title II program or the SSI program.

I am not sure, I don't know where I would get the data to answer your original question, but I think it probably is true that for people who are able to use the ADA to foster remaining in the work force and getting accommodations from their employers to help them remain at work, the longer they can stay at work before they might possibly end up on the disability programs, the better. It is better for them and obviously better for the system, but I don't know how you would get a handle on that number.

Chairman SMITH. I was just wondering. In terms that SSI is financed and paid for out of the general fund with all of the tax revenues coming in, and if that individual has put in 40 months of work, then it comes strictly from the payroll taxes. So just thinking out loud, is there some accommodation to some of those individuals that work over 40 quarters that are now coming out of the payroll tax, where workers have to pay their tax to cover those benefits, as opposed to less than 40 quarters, then it would be coming out of the general fund.

Mr. NADEL. If I could add, the Social Security Administration is undertaking a very important piece of research which I think will shed some light on your initial question about the natural work history of people with disabilities. We will be undertaking a large-scale disability evaluation study which will extensively study a sample of individuals with disabilities, some of whom are on our roles, some of whom are not on our roles, as well as a sample of nondisabled, which I think will provide a lot of information on the work life, the kinds of factors that have enabled people with disabilities to work, how long they have been able to work and so on.

So while it is not satisfying for purposes of this hearing, I think down the road the agency will be able to provide a lot more information on just that question.

Chairman SMITH. Yes, Ms. Ford?

Ms. FORD. Thank you. I just wanted to comment that from the perspective of the person with disability, if you have earned or if your parent has earned your coverage under Title II, there is a very big distinction between receiving Title II benefits and receiving SSI, and that is, for instance, in your ability to retain your resources and your assets. If someone is not entitled to Title II benefits, and they are disabled, and they desperately need support, they will have to impoverish themselves in order to become eligible for SSI. So the difference in the quality of life, especially when looking at someone who may have put the time in in the work force, or the parent has put the time in in the work force, is quite significant. I don't know if that helps in where you are going.

Chairman SMITH. A former Commissioner of Social Security once suggested to me that one reason that individuals that might not otherwise be qualified for disability benefits were going on Social Security disability was because of pressure from Members of Congress that kept calling the Social Security Administration saying, "look, I have the signed doctor's report, put this person on Social Security." So I would like your reaction to whatever validity that might have and whether you can withstand that political pressure?

Ms. ROSS. We have a very stringent set of rules on the way we determine disability. You actually have to go through a five-step sequence of evaluation which starts with are you doing any work at all currently, and do you have a severe disability, and do you meet our medical listings, can you do your former work, or could you do any work in the economy?

While it is a very complex assessment, and it is certainly subject to a lot of judgment, I would suggest that it is not really subject to a great deal of external pressure.

Chairman SMITH. So the letters that Congress writes the Social Security Administration have no effect?

Ms. ROSS. Well, you have really put me in a tough spot here. I don't know whether to say yes or no. We are always thrilled to hear what you have to say, but I think the process does not lend itself to that kind of pressure.

Chairman SMITH. Ms. Rivers.

Ms. RIVERS. I happen to agree with you. Having a number of people come to our office for help, I have found the qualification process to be very, very difficult, not easy. I don't know if you have had success with writing a letter and having some sort of change of heart for your constituents. That has not been my experience. I have seen it to be a stringent process.

I want to ask you about something else though. Disability is a factor of Social Security coverage that is overlooked sometimes, as is survivors insurance. We tend not to always consider that part of what we get back from our Social Security dollars is this kind of coverage.

I would be curious to know if you could compare and contrast for me how survivors insurance or survivors benefit work under the current system versus how they would work under a system of privatized accounts? I am particularly interested in young families, so where you have a breadwinner who is 30 years old, is killed in a car accident or whatever, and now is left with a young widow with small children.

Ms. ROSS. A lot of the proposals for individual accounts haven't been very clear about what happens in cases of either survivors or disability, so it is hard to say exactly what various people might have meant to put in their plan.

What you certainly could say, you could make two points. One of them is if you are talking about young survivors, then the person who was the worker who was trying to accumulate this private account has had a relatively shorter time than if he or she had gotten all the way to retirement age. So there would not be as much money in that account for a young survivor as there would be for a retiree.

Secondly, to the extent that the rest of the Social Security program had benefit reductions of any sort in order to accommodate the individual accounts or a transition period, then this young survivor will probably have a different kind of benefit formula; maybe something will have happened to the CPI that would reduce it. So they might be disadvantaged in two ways. So I think that is a real concern. As Ms. Ford said, it is the same with disabled persons. I will provide more information for the record.

[The information referred to follows:]

In general, widow(er)s, children and dependent parents of insured deceased workers may be eligible for survivor's benefits if they meet certain eligibility requirements. The basic Social Security benefit amount that the survivor beneficiary receives is a percentage of the deceased worker's primary insurance amount (PIA), or basic Social Security benefit amount. For example, a widow(er) first taking survivor's benefits at age 65 may receive up to 100 percent of the PIA, subject to any reduction in the PIA due to the worker electing early retirement, but not less than 82½ percent of the PIA; a widow(er) at any age (with the worker's child under age 16 in care) receives up to 75 percent of the PIA; and children of the deceased worker also may receive up to 75 percent of the PIA.

There is a limit to the amount of money that can be paid to a deceased worker's family each month. The limit varies, and ranges from 150 to 188 percent of the deceased worker's PIA. Generally, benefits payable to the family members cannot exceed this limit.

Finally, there is a one-time payment of $255 that can be paid to a spouse or minor children who meet certain requirements.

Chairman SMITH. If the gentlewoman would yield, do some of the programs have an offset, for every $5 you might earn in your private investment account, you would have a reduction of $4 in your fixed benefits program? Some proposals assume a 3.7 percent increase, but it is only somehow what you earn in your private account. Most proposals would only be offset to what you earned.

Ms. RIVERS. The question I would have about that, not to the panel so much, but the thing that has been very frustrating to me and difficult to understand is people come forward with plans, and the answer to virtually every concern is we would keep that part of Social Security. Then I am at a loss as to how the savings can be as great or if there is as much money as sometimes is argued. If you keep the disability section of it, if you keep the survivor section of it, if you keep a minimum benefit, as many people argue, essentially a floor, and you do all these things, I don't see how there is enough money to move into a new system that is going to have any sort of real effect on people, or people are not being reasonable when they consider their transition costs.

Chairman SMITH. If the gentlewoman would yield. But here again, and maybe we depend too much on the actuaries at the Social Security Administration, but supposedly, hopefully, all of those issues are being taken into consideration.

Mr. Holt.

Mr. HOLT. It is my understanding that there has been some specificity lacking in proposals for reform of the system when it comes to disabilities. I want to understand just how much room there is.

It seems to me that the definition of eligibility, the definition of disability, is pretty much cut and dried, and there is not a lot of room for redefinition there. But I would like to—as it is applied now. Certainly in our society at large, there is a lot of room for definition, a definitional range in what constitutes disability.

I would like to find out what—well, I guess the general question, I am not sure how you would answer this, is how much variability you see possible in the definition of disability. But my specific question is how much of your effort, how much of your resources, how much of the administrative costs goes into assessment and the determination of eligibility, the determination of how someone matches the definition, how someone's condition matches the definition?

Ms. ROSS. Our disability determination is a very labor-intensive process which requires the collecting of a great deal of medical data and then a considerable amount of assessment of people's capacity to continue work. So I would say a large part of our expenditures in the disability program are to make that determination.

You mentioned something that might be important. You said the definition is cut and dried, and I think you meant it was pretty much settled, at least in law, that you were unable to do any work in the whole economy.

Mr. HOLT. That is right.

Ms. ROSS. How you evaluate that continues to change. That is pretty complex, and we are trying to do things like keep up with medical advances and medical technology so that we understand what now means the inability to work. So we continue to try and refine our definition—no, refine our determination of are you disabled, while working with the same definition.

So it is probably a very large part of those administrative costs.

Mr. HOLT. Can you give me a percentage, a figure, anything closer to a dollar amount or percentage?

Ms. ROSS. I can't do that right now, but I would be glad to supply it to you.

[The information referred to follows:]

In fiscal year 1998, it cost about $352 for the State Disability Determination Service to process a disability case.

Mr. HOLT. Thank you. That is all for the moment.

Chairman SMITH. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I apologize for being late. I had another engagement I had to attend. So I apologize for missing your testimony.

But in your testimony, have any of you all explored the possibility or the efficiency or lack thereof of trying to privatize the disability side of Social Security? We have had a lot of people come and talk about the retirement supplement benefit and debating the potential privatization, but most of the plans, if not all of the plans we have looked at, have assumed some sort of flat disability benefit.

Would that be the concurrence of the panel today, that it would remain as a government-sponsored benefit through the payroll tax?

Ms. ROSS. When I provided my testimony, I spoke specifically to the comparison between the Social Security Disability Insurance program and private long-term disability, and one of the most important things we want to emphasize is that in moving to something other than this pool where everybody can be a member regardless of your prior history or your projected future, if you move to a system where there is significant underwriting, where we look at individuals and their risks, as would happen in a private system, you are very likely to have much higher costs for individuals, and you are very likely to have some people who are excluded entirely.

So if you are looking for a way to insure the entire population against the loss of income due to disability, it seems virtually impossible to do it with private insurance.

Mr. BENTSEN. As the Chairman pointed out in his opening statement, the Chairman of the Federal Reserve, Alan Greenspan, had testified before the group, before this panel, and had discussed his experiences as the Chair of the Greenspan Commission back in 1982 and 1983 and the recommendations they made at the last time Social Security was adjusted, and stated one of the reasons why he felt there were adjustments, if I interpret this correctly, why their adjustments had not achieved a 75-year solvency level was because of the exploding costs in the disability side of Social Security.

Ms. Ross, based upon that and your statement, and I would be interested in what the others have to say, is there a case to be made—if there is really no private market system available to provide universal disability coverage, is there a case to be made that this very well could be a program that should be underwritten more from general government revenues rather than a specific payroll tax deduction revenue stream?

Ms. ROSS. I would like to go back to some of the reasons we think that change in the disability rolls has occurred. I am not sure they are the kinds of things that would lead you to that conclusion.

The high unemployment in the early 1990's was one of the things that caused the most rapid increase in our roles, and that sort of thing is cyclical, or recently not. But in any case, the economy goes up and down, and we may be able to accommodate to that.

There were changes in laws and changes brought about by court decisions in the 1980's and early 1990's that made substantial differences in disability, and those things, I think, are things within someone's control.

Then Ms. Ford also talked about the fact that there were medical advances such that people who might otherwise have died now are living longer lives, even if they have a disability.

So a lot of these things are things that can be foreseen, and we can do something about projecting the costs of those.

I am not sure that I would give up on a social insurance system. I think this is a huge pool. We cover everyone, and I think with the proper kind of costing, we could do it in a social insurance payroll tax environment rather than a general revenue environment.

Mr. BENTSEN. Ms. Ford.

Ms. FORD. I would like to comment. We take the position that it should be done as social insurance, that that is the only way it would work. People with disabilities simply will not get private insurance if they already have an impairment. Many families cannot afford it. There already is private disability insurance on the market, and I am not sure exactly what the numbers are, but it is generally higher-income people who can afford to purchase it for themselves.

Social Security Disability Insurance and survivors and retirement insurance are unique in that the system will also pay for the family members, and not just the person who is disabled.

When a program is paid for out of the general revenues, it tends to be means tested, and we are talking about people who have worked and paid FICA taxes as essentially insurance premiums. To means-test a program means that those folks who may have worked for many years or their parents may have worked for many years would be forced to impoverish themselves in order to qualify for a means-tested program. So we are absolutely in opposition to taking that kind of approach.

Mr. BENTSEN. Let me say, and I am not necessarily advocating this transfer, and I was just talking with the staff, in 1997, and it is possible people may look back on the 1997 balanced budget agreement and say it was not all that it was cut out to be, but nonetheless, in 1997, as part of the Medicare portion of the budget, we did transfer some of the home health care function, because that was a spiraling cost, from Part A, the Hospital Insurance Trust Fund, to Part B, which, as you know, includes a significant—well, it is basically all general revenue, except for the premium and deductible and copay of the beneficiaries. It is still a universal program.

Now, that could be viewed two ways. That could be viewed, one, as just a cost shift to bolster the Part A. It could also be viewed as, and the case was made, that this was more of an outpatient program and thus deserved to be under Part B.

The question is whether or not that sets a precedent that should be explored with respect to disability, because even though Part B of Medicare is an optional program, it is still—if I understand correctly, it is still universally available, and whether or not the same would be said if you moved SSDI in that same type of direction.

Of course, the other side of the coin is the fear that somehow bringing general revenues in will put the Mark of—the stigma of welfare or public assistance onto the program. That is yet to happen in Medicare. I don't know whether the same would be the case here or not.

Ms. ROSS. The business about shifting from one revenue source to another, it seems to me what we really want to be sure of is that we have a program that is running appropriately, that we have it under control, so to speak, regardless of what its revenue source is, so that we ought to be making sure that we do things like emphasize our return to work program so that people who can move off do; that we do continuing disability reviews so that we make sure that people who are no longer meeting our eligibility requirements are removed from the roles; and that we improve our decision-making, which is something going on now, so we are making the best decision with the most complete information we can. I think we want to be working on those things for sure.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman SMITH. Deputy Commissioner Ross, you stated in your testimony that 25 to 30 percent of 20-year-olds will become disabled before retirement. Are you suggesting that 25 to 30 percent of all beneficiaries are receiving benefits based on disability?

Ms. ROSS. About a third of our whole beneficiary population is either receiving disability or survivors benefits. What I am telling you with regard to my illustration was that if you take a set of 20-year-olds, at some time during their lives, they will have come onto our roles and received disability benefits. Some of them may actually die and not live on to retirement. Actually about 23 percent of our disability beneficiaries die within 5 years. But I am definitely saying if you look at today's 20-year-olds as they are entering into the work force, 25 to 30 percent of them will have been disability beneficiaries before they reach retirement age.

Chairman SMITH. It seems high. Maybe we should be looking at our working conditions. Maybe we should be looking at something to react to what seems to be a very high percentage.

Let me ask you this question, because I am not sure I know how it works. If a worker has mentally impaired kids, and that worker goes on Social Security at age 65 and then dies at age 70, will those kids continue to receive Social Security benefits, and will they be any different than if that individual had gone on disability before retirement? Ms. Ford.

Ms. ROSS. Yes, those are the people I am referring to as adult disabled child. If you are an adult who is disabled during childhood, which is defined in this case up to age 22, during those developmental years, if you were severely disabled enough to qualify essentially under the disability definition, you receive benefits off your parents' history. So if the parent retires at 65 and dies at 67, the adult disabled child is receiving benefits from that parent's work history for life.

Chairman SMITH. The benefits are the same; whether that parent might have gone on disability at age 60 or whether they retire at 65, the benefits ultimately after the death of the worker for those kids are the same?

Ms. FORD. I am not sure if the calculation turns out to be the same.

Ms. ROSS. The benefits for anybody relate to the earnings of the person who was the worker. So if a person became disabled and had lower earnings in the years they were working, their benefit would be lower than if they had a full healthy life and worked all the way up to 65 at a better-paying job, for example. So it is not just the child gets a certain specified amount. The child gets a portion of whatever the worker would have gotten.

Chairman SMITH. Yes, Ms. Ford.

Ms. FORD. And that becomes an issue when you look at the plans that look at annuities. If the parent is required to purchase an annuity using a private account at retirement, under a typical annuity situation and as described in some of the plans, at death that would go into the estate. You don't have the same kind of ability to support that adult disabled child for life. Some may live 20, 30, 40 years beyond the parents, and Social Security will pay for that, but those annuities probably won't.

Chairman SMITH. Deputy Commissioner Ross said earlier that in their reexamination of those currently on disability, they are finding 6 percent that they feel now can go back to work. As a legislator I get calls on a regular basis complaining about somebody that went on disability that is out playing golf or doing other work, et cetera, and I am sure you get some of the same complaints through your IG.

But tell us more about Social Security's fraud hotline and other fraud and abuse initiatives now under way.

Ms. ROSS. I don't have a lot of specifics to tell you, but the emphasis on the integrity of our program and antifraud has been an emphasis over the past couple of years not just of our inspector general, but of the Social Security Administration itself, and we have worked together with our inspector general to look especially in the disability area for any kind of fraud. So we are quite vigilant in that regard.

Chairman SMITH. So if a person wanted to call in to the Social Security Administration and complain about somebody they felt was really not eligible for these benefits, how would they call your hotline?

Ms. ROSS. I bet somebody can tell me the hotline number, but those are exactly the kind of calls that the inspector general's hotline is there to take.

Chairman SMITH. Can they look it up in the telephone book in some way under probably—I as a legislator should know the answer as well as you.

Ms. ROSS. If anybody called our usual 1-800 number and said, I need the number for the inspector general's hotline, they could give it to them. Actually I have it in front of me right now. But I think going through our main 800 number would be the way to make sure.

Chairman SMITH. What is the main 800 number? You would just call——

Ms. ROSS. What is the main number? This is the first time I have ever had to answer this question. 1-800-SSA-1213. That is pretty easy. So that 1-800-SSA-1213 would tell you how to get to our hotline if you needed it.

Chairman SMITH. Let me finish off. What are the major reasons for going on disability?

Ms. ROSS. You mean, what are the categories of impairments? The most common impairment now is a mental impairment. That is the largest single category of impairments. But there are a lot of other categories which have a fair representation.

Chairman SMITH. A mental impairment is the major reason for going on disability?

Mr. NADEL. It is the single largest. It doesn't mean that most of the people are mentally impaired. It is the single largest category.

Chairman SMITH. Ms. Ford.

Ms. FORD. And a significant proportion of them, and I don't have the number off the top of my head, of people with mental impairments, have mental retardation. Mental retardation is included in the category of people with mental impairments under Social Security's definitions.

Chairman SMITH. So these individuals had some impairment before they started their working career, if I can use that word; is that reasonable to assume?

Ms. FORD. People with mental retardation would have, since it occurs in childhood.

Chairman SMITH. But a person that doesn't have mental impairment can somehow develop mental impairment, and that is one of the largest reasons for going on disability? That is interesting.

Ms. FORD. That would include significant psychiatric disorders and other mental impairments, yes.

Chairman SMITH. To the extent this is a new disorder developed or whether it has been long-lasting, does the Social Security Administration have any kind of statistics or records to be able to tell how many were working with some disability before they went on disability? Do we have anything in our records that would let us know how many, when it is new, and when it just got to the point when it is no longer able for that individual worker to be able to sustain that kind of work?

Ms. ROSS. One can deduce that most times mental illness, not mental retardation, has some progress, and these are people—we are talking about people who have mental impairments who have worked a good deal of time and paid payroll taxes.

Chairman SMITH. At least 40 months or else they would not be eligible.

Ms. ROSS. Forty quarters.

Chairman SMITH. I mean, 40 quarters, yes.

Ms. ROSS. So, yes, there is a very high likelihood we have people dealing with some sort of mental impairment while they were working.

Chairman SMITH. Does that mental impairment include alcohol and drug addiction?

Ms. ROSS. Those are categories that have been excluded as a reason for becoming eligible for disability.

Chairman SMITH. The gentleman from Texas, Mr. Bentsen.

Mr. BENTSEN. Thank you. I have a couple of questions. The drug and alcohol, is that part of the SSDI reforms in 1995-1996, or was that internal?

Ms. ROSS. It was a provision of Public Law 104-121, the Contract With America Act of 1996.

Mr. BENTSEN. They defined what would not be considered. Otherwise you were under court rulings and other reasons that you had to expand.

Ms. ROSS. Right.

Mr. BENTSEN. As I recall, back when Congress passed those adjustments, there was also concern about expansion of the SSDI program for things like—if I recall correctly—attention deficit disorder, and that there was concern for potential abuse of that. But didn't the law try and sort of clamp down on that; is that correct?

Ms. ROSS. There were changes in the SSI program that tightened the eligibility requirements for SSI children.

Mr. BENTSEN. That was SSI. We are talking about a different program. When you are talking about mental impairment as the largest single program, including mental retardation, when you were talking about that, you are not talking about that as being 60, 70 percent, you are talking about that being a 25 or 30 percent share against loss of a limb or some other type of category, right? Is physical impairment still a majority of disability cases?

Ms. ROSS. I think that mental impairments are a third or so of the disability insurance category.

Mr. BENTSEN. I am not trying to discount mental impairment as a realistic impairment. It is.

Ms. ROSS. Among the DI beneficiaries, I think it is about a third, which would lead to your conclusion that two-thirds are probably physical impairments. I will provide more detailed impairment information for the record.

[The information referred to follows:]

OASDI CURRENT-PAY BENEFITS: DISABLED WORKERS

[Number and percentage distribution, by diagnostic group, and sex, December 1998]

Diagnostic group	Number			Percentage distribution		
	Total	Men	Women	Total	Men	Women
Total	4,698,560	2,737,444	1,961,116	....	....	....
Diagnosis available	4,568,391	2,647,721	1,920,670	100.0	100.0	100.0
Infectious and parasitic diseases[1]	93,776	72,695	21,081	2.1	2.7	1.1
Neoplasms	127,174	64,436	62,738	2.8	2.4	3.3
Endocrine, nutritional, and metabolic diseases	233,724	95,498	138,226	5.1	3.6	7.2
Diseases of blood and blood-forming organs	11,349	5,579	5,770	.2	.2	.3
Mental disorders (other than mental retardation)	1,215,373	668,245	547,128	26.6	25.2	28.5
Mental retardation	243,745	166,459	77,286	5.3	6.3	4.0
Diseases of the:						
Nervous system and sense organs	441,016	236,198	204,818	9.7	8.9	10.7
Circulatory system	526,573	368,138	158,435	11.5	13.9	8.2
Respiratory system	159,869	87,592	72,277	3.5	3.3	3.8
Digestive system	61,541	34,657	26,884	1.3	1.3	1.4
Genitourinary system	74,888	46,026	28,862	1.6	1.7	1.5
Skin and subcutaneous tissue	11,826	5,151	6,675	.3	.2	.3
Musculoskeletal system	1,024,053	571,058	452,995	22.4	21.6	23.6
Congenital anomalies	8,719	4,722	3,997	.2	.2	.2
Injuries	224,388	163,631	60,757	4.9	6.2	3.2
Other	110,377	57,636	52,741	2.4	2.2	2.7

[1] AIDS/HIV records are counted in the Infectious and Parasitic Diseases group. Before 1990, these records were included in the Other group.

Mr. BENTSEN. And am I right that the President proposed, as have Members of both parties in the past, is it that people with SSDI who went back to work, who were able to, because of wellness or different working conditions or whatever, able to go back to work, that they would not forfeit their Medicare benefits; is that correct? That is what the President proposed? Or is it Medicaid?

Ms. ROSS. If you are talking about the provision in the Kennedy-Jeffords bill——

Mr. BENTSEN. Right.

Ms. ROSS. There is an expansion of Medicare coverage. Over the next several years, people will be able to get much extended Medicare coverage.

Mr. BENTSEN. Under current law, if you have achieved disability, and if you then go back to work, you have an income cap; is that right?

Ms. ROSS. That is right.

Mr. BENTSEN. If you exceed that cap, you forfeit benefits, including health benefits?

Ms. ROSS. There is an extended period of eligibility for both cash benefits and lasting a couple of years, 3, I believe.

Mr. BENTSEN. Does the SSA—do you have any empirical data that would lead to the conclusion that even with the 3-year cap, that that is an impediment to people who might otherwise be able to return to the work force from running? Does that keep them from returning to the work force?

Ms. ROSS. I am aware of a study that the General Accounting Office did talking to people who were actually working disability insurance beneficiaries, and they asked them what were the things that were of major concern to them, what were they fearing even though they were working, and it was the loss of their medical insurance coverage.

Knowing you are going to lose your Medicare coverage in 3 years, without having any idea whether there is anybody who will cover you regardless of whether you could afford it, is a real threat. You think most of us would think twice about whether we were willing to jump off that.

Mr. BENTSEN. Unless you were 62.

Ms. ROSS. True.

Mr. BENTSEN. I will say this, and the gentleman is right, of course, we get all kinds of calls, but we get calls from people that say this is being abused. At the same time, I have to tell you, my case-working staff who deals with people, trying to work with constituents who are trying to get their disability designation and going through that process, they sometimes feel like they are banging their head against a wall and the time it takes to do it. I hope that is because of SSA or whoever it is that does it is dotting their I's and crossing their T's and making sure that somebody meets the qualifications.

Chairman SMITH. If the gentleman will yield, Deputy Commissioner Ross indicated that when she gets a call from a congressional office, that they don't give it undue regard.

Mr. BENTSEN. I am not sure I understand exactly, but is that a double or a triple negative? Does that mean we can just call your office any time?

Ms. ROSS. You are welcome to call any time.

Mr. BENTSEN. You are careful to say that, I am sure.

Thank you, Mr. Chairman.

Chairman SMITH. Thank you all very much. I would like to conclude and ask each one of you if you would have a closing comment of something that the Task Force, the Budget Committee, Congress should take into consideration or be aware of, or something that might not have been said that you feel should have been said? We will go from you, Ms. Ford, to Mr. Nadel to Ms. Ross.

Ms. FORD. I think I have probably said it. Overall the Consortium for Citizens with Disabilities believes the system works, and we have to preserve the social insurance aspect of the disability programs.

Chairman SMITH. Mr. NADEL.

Mr. NADEL. I again would reiterate the importance of the social insurance aspects of the programs, which enjoy broad public support, where people feel that they have paid in and have a right should terrible misfortune befall them.

Chairman SMITH. Ms. Ross.

Ms. ROSS. I just would suggest that when you are looking at various solvency proposals, that you look particularly at survivors and disability benefits, what results from a change in one place, what is the consequence for these individuals viewing it separately rather than as part of the whole package.

Chairman SMITH. You have an interesting comment, Mr. Bentsen, that maybe we should consider if an individual works only 39 quarters, then they would be going on SSI paid for out of the general fund. Maybe there is a way to accommodate the increasing the work quarter requirement without forcing those individuals that were between 20 and, say, 40 work quarters to sell out everything they had to be eligible for the SSI benefits, because it seems to be more of a program that should be accommodated by the general public. That was an interesting suggestion that I wrote down, and maybe we will look at incorporating it.

Let me just announce next week we will be starting at 10 o'clock. We will be starting with a review of some of the Social Security proposals, and Senator Gregg and Senator Breaux will be here at 10 a.m. At 10:30, Congressman Archer will testify on his proposal; at 11 a.m., Congressman Kolbe and Congressman Stenholm. We will proceed with other plans, including the one that I have developed, and this Task Force can review some of the aspects of those different plans.

I would thank our witnesses today very much for giving your time and coming to this hearing. The Budget Committee Task Force is adjourned.

[Whereupon, at 1:35 p.m., the Task Force was adjourned.]

Review of Social Security Reform Plans

TUESDAY, JUNE 29, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 10:07 a.m. in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Chairman SMITH. The Budget Committee Task Force on Social Security will come to order for the purpose of hearing individual reports on their proposals to save Social Security.

I certainly welcome the witnesses here today as we look to specific Social Security reform proposals offered in Congress. Nothing is more important to this country's long-term budget prospects than resolving the funding gap in Social Security and Medicare, and I congratulate the Members that have had enough courage to move ahead with solutions. Solutions are not easy, they are difficult, and it takes some exceptional wisdom and statesmanship to move ahead.

Today we will hear many different ideas about how we should reform Social Security. Our witnesses will undoubtedly disagree on some of the issues with each other and with members of the Task Force. That is only to be expected on an important issue like Social Security. It is extraordinary, I think, to note that there is one thing that every single witness agrees on. This is something that the President and all the members of the Social Security Commission also agree on, and the single point of agreement is the investment of Social Security funds in the private securities market. We all agree that this investment, whether held by government or by individual workers, is necessary to increase the return on the surpluses now coming into Social Security.

I hope that we all take note of this agreement. It is something that did not exist up until the last couple of years. And when I first introduced my Social Security bill and started writing it in 1993, there was very little support and very little interest in moving ahead. I think we have made significant progress, and I firmly believe that investment is an important part of the eventual bipartisan compromise that will be necessary if we are going to protect and strengthen Social Security for the future. Let's hope that we can work together so that we can reach this compromise as soon as possible for the sake of current and future retirees, and I look forward to the testimony.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

I welcome the witnesses here today as we look at specific Social Security reform proposals offered in Congress. Nothing is more important to this country's long-term budget prospects than resolving the funding gap in Social Security and Medicare.

Today, we will hear many different ideas about how we should reform Social Security. Our witnesses will undoubtedly disagree on various issues with each other and with the members of the Task Force. That is only to be expected on an issue as important as Social Security.

It is extraordinary, therefore, to note that there is one thing that every single witness today agrees on. This is something that the President and all the members of the Social Security Commission also agree on. This single point of agreement is the investment of Social Security funds in the private securities markets. We all agree that this investment, whether held by the government or by individual workers, is necessary to increase the return on the surpluses now coming into Social Security.

I hope that we all take note of this agreement. It is something that did not exist when I started working on my first Social Security bill in 1993 and represents real progress in the debate. I firmly believe that investment will be the basis of the eventual bipartisan compromise legislation that will be necessary to protect and strengthen Social Security for the future. Let's hope that we can work together so this compromise can take place as soon as possible.

I look forward to today's testimony.

Chairman SMITH. Representative Rivers.

Ms. RIVERS. Thank you, Mr. Chairman. I want to thank the two Senators as well as all of the others who will be presenting today and to commend you on your courage. There are a lot of people who are talking about Social Security, but only a handful who are actually coming forward with proposals. I want to apologize, however, because I am dealing with an especially vicious summer cold and will not be able to stay for the entire hearing. But I look forward to hearing from you, and I will review all of your materials very carefully, thank you.

Chairman SMITH. Senator Gregg, Senator Breaux, proceed with whatever time you think is appropriate. Leave us some time for questions, and please proceed.

STATEMENT OF HON. JUDD GREGG, A UNITED STATES SENATOR FROM THE STATE OF NEW HAMPSHIRE

Senator GREGG. Thank you very much, Mr. Chairman. It is a pleasure to have a chance to talk with you today, and I congratulate you, Mr. Chairman, on your efforts in the area of Social Security. They have been a significant contributor to making this process viable and to moving forward toward Social Security reform, which is absolutely essential if the next generation of Americans are to have a system which they can benefit from.

Senator Breaux and I have been working on this issue for about 2½ years now, initially as a Chairman, Cochairman, along with Senator—Congressmen Kolbe and Stenholm—of the CSIS Commission, which involved a large number of people interested in this issue. From that commission we developed a bill which we felt was an extremely positive step forward, and that bill has received a fair amount of notoriety.

Since then, however, working with other Members of the Senate, Senator Kerrey, Senator Grassley and a number of other Members who have been interested in this issue, we have put together an additional piece of legislation which has taken the original bill that we proposed and expanded on it and I think made it much stronger and a much more constructive piece of legislation, and I will outline what this piece of legislation does. We call it the bipartisan Social Security plan because it is bipartisan with Senator Breaux and Senator Kerrey, Democratic Members, Senator Grassley and myself being Republican Members, and 15 cosponsors or something in that range of bills similar to this within the Congress. And so it does have broad interest.

The basic goal of the legislation is to accomplish a number of things. First, we came to the conclusion that we should go for a long-term solvency. We shouldn't have a short-range plan. The President's plan, as you recall, really only projected through the year 2050. Our plan goes to the end of the next century, and as far as the eye can see beyond that for all intents and purposes, so it makes the system solvent for not only 75 years, but perpetually, which is very important.

Second, our plan has no major, no significant tax increases and, in fact, represents over the term of the plan a significant tax reduction over present law; a dramatic tax reduction over present law and significant tax reduction over what many of the other plans which have been put forward, including the President's proposal, in the Ways and Means plan, in our opinion.

Fourthly, the plan is concerned with intergenerational fairness. In other words, we feel very strongly that younger people who are already getting a rather raw deal under the Social Security System of a very low rate of return should not have that aggravated by any attempt to try to correct the system. We should not end up increasing the tax burden of younger people. We should not end up putting younger people at further disadvantages to their likelihood of getting the Social Security benefit they are paying for, and paying rather dearly for at this time, so our plan addresses that in a positive way.

Our plan doesn't touch any current beneficiaries of the Social Security system so that there is no impact on current beneficiaries. They can participate in our savings accounts if they want to, I suppose, but as a practical matter it says to current beneficiaries, you are protected.

Fifth, our plan is very progressive. In other words, we make a special effort to make sure that people at the low income levels get a significant benefit, and we have a benefit which dramatically—which is dramatically better than what present law is or than what, as we understand, any other bill's proposals are relative to low- and moderate-income individuals, independent of the personal savings accounts which we have in our plans, so that even if the personal savings accounts are not considered, our plan is extremely progressive in its approach.

Sixth, and I think most important, is we begin the process of prefunding the liability of the Social Security System. There are only really three ways that you can address the insolvency of the Social Security System. One, of course, is to raise taxes. Two is to significantly cut benefits. Three is to prefund the liability, the contingent liability, of the system. We accomplish this through personal savings accounts. Our personal savings accounts are structured much like the other ones, including the Chairman's personal savings accounts, although we don't have it grow as aggressively as the Chairman's does in the outyears. Our personal savings accounts are structured so that it begins at a 2 percent level, although people in lower income brackets will be able to get 4 percent through a matching system with the Federal Government contributing, and so that they can have a higher tax refund, almost 4 percent. And that personal savings account is then the asset of the retiree, which is a very significant point.

In a number of plans that are floating around, the personal savings accounts and the amount of money that is earned in those personal savings accounts is essentially taken by the Federal Government as a claw back at the time of retirement. Ours does not take that approach. Ours you keep your personal savings account. It is yours. If you die prior to retirement, it becomes an asset of your estate, and you benefit from its growth.

We structured the personal savings accounts so that there is a reduction in your benefit at retirement, actuarial reduction, which is represented by what your personal savings account would have generated if it had earned only the rate of T-bonds. In other words, if you had taken the most conservative investment, that ends up being an actuarial reduction in your benefit at retirement, but since almost everyone will be generating more than their T-bond rate, there is very little question that you will end up with a personal savings account at retirement that will be a significant contributor to your assets and to your own personal wealth.

In addition, the way we invest the personal savings accounts is we do it using the model of the Thrift Savings Plan so that essentially the Thrift Savings Plan, which all of us in Congress are familiar with, is the same type of vehicle that you would have to use as your investment vehicle under the personal savings accounts. So you would have a choice every year of three our four, maybe five or six different funds which would have been set up by the trustees of the Social Security Administration under a Thrift Savings Plan type of structure.

So we have three major functions here: One, we don't raise taxes, and I think this is a critical point, one which I want to stress a little bit further, where all of the plans out there today that are being talked about besides this plan and the Chairman's plan end up with a huge tax increase in the transition years because they use the general fund to essentially support the Social Security System. Now, historically we have never used the general fund accounts to support Social Security. And it would be, in my opinion, a major mistake to use the general fund in an extraordinarily aggressive way to support the Social Security System.

But what almost all of the plans do, especially——

Chairman SMITH. I am going to ask the visitors today to refrain from moving up while testimony is proceeding to get copies. We can take a break in a minute and let everybody come up and get another copy.

Senator Gregg, excuse me. Proceed.

Senator GREGG. Under the President's plan, and the Ways and Means plan to a great extent, you end up with the general fund tax burden increasing significantly in order to bear the burden of obtaining solvency in the Social Security Trust Fund, which means that especially wage earners and younger wage earners end up with a double hit. They end up with less benefits in many instances than their parents. More importantly, they end up with a much higher tax burden than their parents in order to support the burden of the Social Security reform.

Our proposal does not do that. Our proposal maintains a tax burden which is consistent with the present-day tax burden, and does not presume any significant general fund, and, in fact, would be a huge tax reduction in comparison to either general law or the President's proposal or the Ways and Means proposal relative to the use of general funds. So we see that as a very big positive.

I notice that my time is up, but let me simply highlight again we prefund the liability. We give ownership. We don't raise taxes, and we make the system solvent for the next 100 years, and it is a bipartisan plan. And it has been scored by the Social Security trustees.

[The prepared statement of Senator Gregg follows:]

PREPARED STATEMENT OF HON. JUDD GREGG, A UNITED STATES SENATOR FROM THE STATE OF NEW HAMPSHIRE

Thank you, Mr. Chairman, for this opportunity to testify before your Task Force. As you may know, I serve as the chair of the Budget Committee Task Force on the Senate side, so I understand something of your current responsibilities. I want to commend you for your leadership in holding this hearing, and also for offering a reform proposal of your own.

The proposal that I will discuss was negotiated over several months by a bipartisan group of committed reformers in the Senate. It already has more cosponsors than any other competing proposal. Those cosponsors include myself, Senator Bob Kerrey, Senator John Breaux, Senator Chuck Grassley, Senator Fred Thompson, Senator Chuck Robb, and Senator Craig Thomas.

Mr. Chairman, I would like to begin by stressing that our plan is not the work of any single legislator. Each of us had to make concessions that we did not like. But we also benefited from our decision to employ the best ideas that we could find from serious reform plans presented across the political spectrum. One of these ideas, you may have noticed, derives from a similar provision in your own proposal. It therefore seems appropriate to begin with a description of it.

In the last Congress, I worked with Senator Breaux as well as Congressmen Kolbe and Stenholm to develop a proposal that was actuarially sound, and would also improve the quality of the deal provided to Social Security beneficiaries, especially today's young workers. Our calculations persuaded us that most individuals would benefit from the reforms that we proposed, either in terms of increased benefits, or decreased tax burdens, or some combination of both. Despite this, it was not very difficult for detractors to take "pot shots" at our proposal. Critics could pick out one provision that in isolation would reduce benefits, and ignore the provisions that increase them. Or they could charge that the provisions to ensure fiscal responsibility were made necessary only because we were determined to embrace personal accounts at all cost. These criticisms are not persuasive to those who have analyzed the entirety of the effects of our reforms, but they are sometimes made nonetheless, so we needed to be sure that the benefits of our reforms were clearly understood.

In drafting this year's legislation, therefore, we sought a way to demonstrate to people that personal accounts were not the cause of any "benefit cuts," that by contrast, the accumulated savings in personal accounts could be an important cushion against the types of outlay restraints that are necessary to balance the current Social Security system, much less a restructured one. We found that the provision in your legislation that established an exact offset of benefits, equal to the interest-compounded value of the tax refund into the personal account, was a useful means of achieving this. In its effects, it is very similar to "bend point factor" changes that we offered last year. But to help in presenting our proposal to the public, we felt that there was something to be gained by changing the nature of the offset.

By making the benefit offsets exactly proportional to the interest-compounded value of the tax refunds placed in personal accounts, you can make a very straightforward deal with beneficiaries. If they don't want to take a risk, if they don't want to "play the game" of stock investment, they don't have to. If they simply invest in T-bonds with their personal accounts, then they come out exactly even. Their benefits will exactly match what they would have been had the personal account never been created. But if they believe that they can do better—and indeed, most of them can—then our proposal gives them the opportunity to do so. It does not "claw back" the proceeds of their investment success. It gives them an opportunity to improve upon the benefits that the system could give them if reformed by traditional methods alone. But it does not force anyone to take a risk that they do not want, and assures them that the personal account itself cannot cause any reduction in their overall benefits.

That is one important element that our proposal has in common with your proposal, Mr. Chairman. Now I would like to describe the other aspects of our plan. It would:

- Make Social Security solvent. Not simply for 75 years, but perpetually, as far as the Trustees can estimate. Our proposal would leave the system on a permanently sustainable path.
- Increase Social Security benefits beyond what the current system can fund. I will follow up with some details as to why and how.
- It would drastically reduce taxes below current-law levels. Again, I will provide details as to why and how it does this.
- It will make the system far less costly than current law, and also less costly than competing reform proposals.
- It will not touch the benefits of current retirees.
- It will strengthen the "safety net" against poverty and provide additional protections for the disabled, for widows, and for other vulnerable sectors of the population.
- It will vastly reduce the Federal Government's unfunded liabilities.
- It would use the best ideas provided by reformers across the political spectrum, and thus offers a practical opportunity for a larger bipartisan agreement.
- It will improve the system in many respects. It will provide for fairer treatment across generations, across demographic groups. It would improve the work incentives of the current system.

I would like now to explain how our proposal achieves all of these objectives:

Achieving System Solvency

Our system would make the system solvent for as far as the Social Security Actuaries are able to estimate.

How does it do this? Above all else, it accomplishes this through advance funding.

As the members of this Committee know, our population is aging rapidly. Currently we have a little more than 3 workers paying into the system for every 1 retiree taking out of it. Within a generation, that ratio will be down to 2:1.

As a consequence, if we did nothing, future generations would be assessed skyrocketing tax rates in order to meet benefit promises. The projected cost (tax) rate of the Social Security system, according to the Actuaries, will be almost 18 percent by 2030.

The Trust Fund is not currently scheduled to become insolvent until 2034, but as most acknowledge, the existence of the Trust Fund has nothing to do with the government's ability to pay benefits. President Clinton's submitted budget for this year made the point as well as I possibly could:

"These balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. * * * They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits."

In other words, we have a problem that arises in 2014, not in 2034, and it quickly becomes an enormous one unless we find a way to put aside savings today. This does not mean simply adding a series of credits to the Social Security Trust Fund, which would have no positive impact, as the quote from the President's budget clearly shows.

What we have to do is begin to advance fund the current system, and that means taking some of that surplus Social Security money today out of the Federal coffers and into a place where it can be saved, invested—owned by individual beneficiaries. That money would belong to them immediately, even though they could not withdraw it before retirement. But it would be a real asset in their name.

By doing this, we can reduce the amount of the benefit that needs to be funded in the future by raising taxes on future generations. This is the critical objective, but it allows for flippant political attacks. If you give someone a part of their benefit today, in their personal account, and less of it later on, some will say that it is a “cut” in benefits. It is no such thing. Only in Washington can giving people ownership rights and real funding for a portion of their benefits, and increasing their total real value, be construed as a cut. Accepting such terminology can only lead to one conclusion—that we can’t advance fund, because we simply have to be sure that every penny of future benefits comes from taxing future workers. So we need to get out of that rhetorical trap.

Our proposal has been certified by the actuaries as attaining actuarial solvency, and in fact it goes so far as to slightly overshoot. We are “overbalanced” in the years after 2050, and have some room to modify the proposal in some respects and yet still stay in balance.

I would note the consensus that has developed for some form of advance funding. This was one of the few recommendations that united an otherwise divided Social Security Advisory Council in 1996. The major disagreements today among policymakers consist only in the area of who should control and direct the investment opportunities created within Social Security. I believe strongly, and I believe a congressional majority agrees, that this investment should be directed by individual beneficiaries, not by the Federal Government or any other public board.

WHY BENEFITS ARE HIGHER UNDER OUR PLAN

We have worked with the Social Security actuaries and the Congressional Research Service to estimate the levels of benefits provided under our plan.

There are certain bottom-line points that should be recognized about our plan. Among them:

1. Low-wage earners in every birth cohort measured would experience higher benefits under our plan than current law can sustain, even without including the proceeds from personal accounts.

2. Average earners in every birth cohort measured would experience higher benefits under our plan than current law can sustain, even if their personal accounts only grew at the projected bond rate of 3.0 percent.

3. Maximum earners in some birth cohorts would need either to achieve the historical rate of return on stocks, or to put in additional voluntary contributions, in order to exceed benefit levels of current law. However, the tax savings to high-income earners, which I will outline in the next section, will be so great that on balance they would also benefit appreciably from our reform plan.

Under current law, a low-wage individual retiring in the year 2040 at the age of 65 would be promised a monthly benefit of $752. However, due to the pending insolvency of the system, only $536 of that can be funded. We cannot know in advance how future generations would distribute the program changes between benefit cuts and tax increases. But we do know that our plan, thanks to advance funding, would offer a higher benefit to that individual, from a fully solvent system that would eliminate the need for those choices.

I will provide tables that are based on the research of the Congressional Research Service that make clear all of the above points. The CRS makes projections that assume that under current law, benefits would be paid in full until 2034, and then suddenly cut by more than 25 percent when the system becomes insolvent. CRS can make no other presumption in the absence of advance knowledge of how Congress would distribute the pain of benefit reductions among birth cohorts. In order to translate the CRS figures into a more plausible outcome, we added a column showing the effects that would come from the benefit reductions under current law being shared equally by all birth cohorts.

BENEFIT TABLE NO. 1

The Bipartisan Plan’s Benefits Would Be Higher for Low-Income Workers Even Without Counting Personal Accounts
[Assumes Steady Low-Wage Worker; Monthly Benefit, 1999 Dollars; Assumes Retirement at Age 65]

Year	Current law (benefit cuts begin in 2034)	Current law sustainable[1]	Bipartisan plan (bond rate, no voluntary)	Bipartisan plan (without account benefits)	Bipartisan plan (with 1 percent voluntary contributions)
2000	626	517	615	606	627
2005	624	515	620	601	645
2010	652	539	698	667	738
2015	673	556	733	687	790
2020	660	545	754	691	832
2030	690	570	776	694	877
2035	512	595	798	693	926
2040	536	621	821	689	981
2050	582	678	869	710	1,051

BENEFIT TABLE NO. 1—Continued

The Bipartisan Plan's Benefits Would Be Higher for Low-Income Workers Even Without Counting Personal Accounts
[Assumes Steady Low-Wage Worker; Monthly Benefit, 1999 Dollars; Assumes Retirement at Age 65]

Year	Current law (benefit cuts begin in 2034)	Current law sustainable[1]	Bipartisan plan (bond rate, no voluntary)	Bipartisan plan (without account benefits)	Bipartisan plan (with 1 percent voluntary contributions)
2060	611	739	920	749	1,107

[1] The Congressional Research Service, in the left-hand column, assumes that all of the burden of benefit changes under current law will commence in 2034. In order to produce a more realistic prediction of how the changes required under current law would be spread, the ''current law sustainable'' column assumes that they have been spread equally among birth cohorts throughout the valuation period.

BENEFIT TABLE NO. 2

The Bipartisan Plan's Benefits Would Be Higher for Average-Income Workers Even if Accounts Earn Only a Bond Rate of Return (3.0 Percent) Assumes Steady Average-Wage Worker; Monthly Benefit, 1999 Dollars; Assumes Retirement at Age 65

Year	Current law (benefit cuts begin in 2034)	Current law sustainable[1]	Bipartisan plan (bond rate, no voluntary)	Bipartisan plan (stock rate)	Bipartisan plan (with 1 percent voluntary contributions, bond rate)
2000	1,032	852	1,014	1,016	1,029
2005	1,031	852	973	982	1,006
2010	1,076	889	991	1,014	1,046
2015	1,111	918	977	1,024	1,057
2020	1,090	900	1,005	1,092	1,115
2030	1,139	941	1,083	1,183	1,179
2035	845	982	1,063	1,307	1,250
2040	884	1,026	1,093	1,476	1,329
2050	961	1,119	1,157	1,672	1,442
2060	1,007	1,221	1,225	1,778	1,531

[1] The Congressional Research Service, in the left-hand column, assumes that all of the burden of benefit changes under current law will commence in 2034. In order to produce a more realistic prediction of how the changes required under current law would be spread, the ''current law sustainable'' column assumes that they have been spread equally among birth cohorts throughout the valuation period.

The alternative course is that current benefit promises would be met in full by raising taxes, both under current law and under proposals to simply transfer credits to the Social Security Trust Fund. I have also provided a table that shows the size of these tax costs, and will comment further upon them in the next portion of my statement.

I would like to point out that these figures apply to individuals retiring at the age of 65. Thus, even with the increased actuarial adjustment for early retirement under our plan, and even though our plan would accelerate the pace at which the normal retirement age would reach its current-law target of 67, benefits under our proposal for individuals retiring at 65 would still be higher.

Our tables also show that the progressive match program for low-income individuals will also add enormously to the projected benefits that they will receive.

WHY TAXES WILL BE MUCH LOWER UNDER OUR PLAN

If there is a single most obvious and important benefit of enacting this reform, it is in the tax reductions that will result from it.

I am not referring to the most immediate tax reduction, the payroll tax cut that will be given to individuals in the form of a refund into a personal account.

The greatest reduction in taxes would come in the years from 2015 on beyond. At that time, under current law—and under many reform plans—enormous outlays from general revenues would be needed to redeem the Social Security Trust Fund, or to fund personal accounts. The net cost of the system would begin to climb. The Federal Government would have to collect almost 18 percent of national taxable payroll in the year 2030, more than 5 points of that coming from general revenues.

The hidden cost of the current Social Security system is not the payroll tax increases that everyone knows would be required after 2034, but the general tax increases that few will admit would be required starting in 2014.

With my statement, I include a table showing the effective tax rate costs of current law as well as the various actuarially sound reform proposals that have been placed before the Congress. These figures come directly from the Social Security actuaries. They include the sum of the costs of paying OASDI benefits, plus any mandatory contributions to personal accounts. (Under our proposal, additional voluntary contributions would also be permitted. But any Federal ''matches'' of voluntary contributions from general revenues would be contingent upon new savings being generated.)

Let me return to our individual who is working in the year 2025 under current law. In that year, a tax increase equal to 3.61 percent of payroll would effectively need to be assessed through general revenues in order to pay promised benefits. As a low-income individual, his share of that burden would be less than if it were assessed through the payroll tax, but it would still be real. Under current law, his income tax burden comes to about $241 annually.

COMPARISON OF COST RATES OF CURRENT LAW AND ALTERNATIVE PLANS

[As a percentage of taxable payroll]

Year	Current law	Archer/Shaw	Senate bipartisan	Kolbe/Stenholm	Gramm	Nadler
2000	10.8	12.8	12.7	12.9	15.0	([1])10.4
2005	11.2	13.3	13.2	13.0	15.2	10.6
2010	11.9	13.9	13.4	13.4	15.6	11.2
2015	13.3	15.0	14.0	14.0	16.4	12.5
2020	15.0	16.4	14.7	14.8	17.3	12.8 (14.2)
2025	16.6	17.4	15.4	15.6	**17.6**	14.4 (15.8)
2030	17.7	**17.8**	**15.7**	**15.7**	17.1	15.5 (16.9)
2035	18.2	17.3	15.5	15.2	16.4	15.9 (17.4)
2040	18.2	16.2	14.8	14.5	15.2	16.0 (17.5)
2045	18.2	14.9	14.3	13.8	14.1	16.1 (17.5)
2050	18.3	13.8	13.9	13.3	13.4	16.3 (17.7)
2055	18.6	13.1	13.7	13.2	13.0	16.6 (18.0)
2060	19.1	12.6	13.7	13.1	12.8	16.9 (18.5)
2065	19.4	12.3	13.6	13.4	12.5	17.1 (18.8)
2070	**19.6**	12.1	13.5	13.7	12.4	**17.3 (19.0)**

[1] Tax rate of Nadler plan is lower than current law not because total costs are less but because amount of national income subject to tax is greater. In order to compare total costs of Nadler plan to other plans, cost rate given in Nadler column must be multiplied by a factor that varies through time. This factor would be close to 1.06 in the beginning of the valuation period, and would gradually decline to 1.03 at the end. For example, the tax rate given as 11.2 percent in 2010 under the Nadler column would equate to the same total tax cost as the 11.9 percent figure in the current law column.

Notes: Annual cost includes OASDI outlays plus contributions to personal accounts. Peak cost year in **bold**. Figures come from analyses completed of each plan by Social Security actuaries. Archer/Shaw plan memo of April 29, 1999. Senate bipartisan plan (Gregg/Kerrey/Breaux/Grassley et al) memo of June 3, 1999. Kolbe/Stenholm plan memo of May 25, 1999. Gramm plan memo of April 16, 1999. Nadler plan memo of June 3, 1999. Nadler plan total cost given in parentheses, cost estimate given on assumption that stock sales reduce amount of bonds that must be redeemed from tax revenue. Due to construction of plans, cost rates for the Archer/Shaw, Gramm, and Nadler plans would vary according to rate of return received on stock investments.)

PART II: COMPARISON OF COST RATES OF CURRENT LAW AND ALTERNATIVE PLANS

[As a percentage of taxable payroll]

Year	Current law	Moynihan/Kerrey
2000	10.8	([1])11.1 (13.1)
2005	11.2	11.0 (13.0)
2010	11.9	10.9 (12.9)
2015	13.3	11.5 (13.5)
2020	15.0	12.2 (14.2)
2025	16.6	13.2 (15.2)
2030	17.7	13.8 (15.8)
2035	18.2	14.0 (16.0)
2040	18.2	14.0 (16.0)
2045	18.2	14.0 (16.0)
2050	18.3	14.2 (16.2)
2055	18.6	14.5 (16.5)
2060	19.1	14.7 (16.7)
2065	19.4	14.8 (16.8)
2070	**19.6**	**14.9 (16.9)**

[1] Like the Nadler plan, the Moynihan/Kerrey plan would increase the share of national income subject to Social Security taxation, but to a lesser degree. Thus, tax rates will appear lower than would an equivalent amount of tax revenue collected under the Archer/Shaw, Gramm, or Kolbe/Stenholm plans. The correction factor required to translate one cost rate into another would be between 1.03–1.06 for the Nadler proposal, 1.01–1.02 for the Senate bipartisan proposal, and 1.01–1.04 for the Moynihan/Kerrey proposal.

Notes: Annual cost includes OASDI outlays plus contributions to personal accounts. Peak cost year in **bold**. Analysis of Moynihan/Kerrey plan is based on SSA actuaries' memo of January 11, 1999, and is listed separately because it is the only projection provided here based on the 1998 Trustees' Report. 1999 re-estimates would vary. Unlike the other personal account proposals, the accounts in the Moynihan/Kerrey plan are voluntary. The figure without parentheses assumes no contributions to, and thus no income from, personal accounts. The figure inside parentheses assumes universal participation in 2 percent personal accounts, for comparison with other personal account plans.

Under our proposal, that tax burden would drop by roughly 37 percent, from $241 to $153.

Middle and high-income workers would not experience benefit increases as generous as those provided to low-income individuals under our plan. But we have determined that by the year 2034, an average wage earner would save the equivalent of $650 a year (1999 dollars) in income taxes, and a maximum-wage earner, $2350 a year. I want to stress that these savings are net of any effects of re-indexing CPI upon the income tax rates. These are net tax reductions, even including our CPI reforms.

I would also stress that 2025 is not a particularly favorable example to select. Our relative tax savings get much larger after that point, growing steadily henceforth.

A look at our chart showing total costs reveals how quickly our proposal, as well as the Kolbe-Stenholm proposal, begins to reduce tax burdens.

A plan as comprehensive as ours can be picked apart by critics, provision by provision. It is easy to criticize a plan's parts in isolation from the whole, and to say that one of them is disadvantageous, heedless of the other benefits and gains provided. One reason for the specific choices that we made is revealed in this important table. The result of not making them is simply that, by the year 2030, the effective tax rate of the system will surpass 17 percent, an unfortunate legacy to leave to posterity.

OUR PLAN PROTECTS THE BENEFITS OF CURRENT RETIREES

How would current retirees be affected by our proposal?

Only in one way. Their benefits would come from a solvent system, and therefore, political pressure to cut their benefits will be reduced. Our proposal would not affect their benefits in any way. Even the required methodological corrections to the Consumer Price Index would not affect the benefits of current retirees.

Under current law, there is no way of knowing what future generations will do when the tax levels required to support this system begin to rise in the year 2014. We do not know whether future generations will be able to afford to increase the tax costs of the system to 18 percent of the national tax base by the year 2030, or whether other pressing national needs, such as a recession or an international conflict will make this untenable. Current law may therefore contain the seeds of political pressure to cut benefits. Moreover, as general revenues required to sustain the system grow to the levels of hundreds of billions each year, there is the risk that upper-income individuals will correctly diagnose that the system has become an irretrievably bad deal for them, and that they will walk away from this important program.

By eliminating the factors that might lead to pressure to cut benefits, our proposal would keep the benefits of seniors far more secure.

STRENGTHENING THE SAFETY NET AGAINST POVERTY

Poverty would be reduced under our proposal, even if the personal accounts do not grow at an aggressive rate. The reason for this is that our proposal would increase the progressivity of the basic defined, guaranteed Social Security benefit. It would also gradually phase in increased benefits for widows.

Moreover, our plan would protect the disabled. They would be unaffected by the changes made to build new saving into the system. Their benefits would not be impacted by the benefit offsets proportional to personal account contributions. If an individual becomes disabled prior to retirement age, they would receive their current-law benefit.

It is important to recognize that we do not face a choice between maintaining Social Security as a "social insurance" system and as an "earned benefit." It has always served both functions, and it must continue to do so in order to sustain political support. The system must retain some features of being an "earned benefit" so as not be reduced to a welfare program only. This is why proposals to simply bail out the system through general revenue transfusions alone—to turn it into, effectively, another welfare program in which contributions and benefits are not related—are misguided and undermine the system's ethic.

Again, I would repeat that our proposal contains important benefits for all individuals. Guaranteed benefits on the low-income end would be increased. High income earners would be spared the large current-law tax increases that would otherwise be necessary. If we act responsibly and soon, we can accomplish a reform that serves the interests of all Americans.

Our Proposal Would Reduce Unfunded Liabilities

By putting aside some funding today, and reducing the proportion of benefits that are financed solely by taxing future workers, our proposal would vastly reduce the system's unfunded liabilities.

Consider such a year as 2034. Under current law, the government would have a liability from general revenues to the Trust Fund equal to an approximately 5 point payroll tax increase. By advance funding benefits, our plan would reduce the cost of OASDI outlays in that year from more than 18 percent to less than 14 percent. The pressure on general revenue outlays would be reduced by more than half.

The Social Security system would be left on a sustainable course. The share of benefits each year that are unfunded liabilities would begin to go down partway through the retirement of the baby boom generation. By the end of the valuation period, the actuaries tell us, the system would have a rising amount of assets in the Trust Fund.

Our Plan Combines the Best Features of Many Reform Plans

We believe that our plan is indicative of the product that would result from a larger bipartisan negotiation in the Congress. Accordingly, we believe that it provides the best available vehicle for negotiations with the President if he chooses to become substantively involved. It was our hope to put forth a proposal on a bipartisan basis, so that the President would not have to choose between negotiating with a "Republican plan" or a "Democratic plan." Stalemate will not save our Social Security system.

Other Aspects of the Bipartisan Plan

The changes effected in our bipartisan bill do not, all of them, relate solely to fixing system solvency.

One area of reforms includes improved work incentives. Our proposal would eliminate the earnings limit for retirees. It would also correct the actuarial adjustments for early and late retirement so that beneficiaries who continue to work would receive back in benefits the value of the extra payroll taxes they contributed. The proposal would also change the AIME formula so that the number of earnings years in the numerator would no longer be tied to the number of years in the denominator. In other words, every year of earnings, no matter how small, would have the effect of increasing overall benefits (Under current law, only the earnings in the top earnings years are counted toward benefits, and the more earnings years that are counted, the lower are is the resulting benefit formula.)

We also included several provisions designed to address the needs of specific sectors of the population who are threatened under current law. For example, we gradually would increase the benefits provided to widows, so that they would ultimately be at least 75 percent of the combined value of the benefits that husband and wife would have been entitled to on their own.

We also recognized the poor treatment of two-earner couples relative to one-earner couples under the current system. Our proposal includes five "dropout years" in the benefit formula pertaining to two earner couples, in recognition of the time that a spouse may have had to take out of the work force.

Our proposal uses the best information available to us about how to administer personal accounts. We have been careful not to place new administrative burdens upon employers. They would continue to forward payroll taxes to the Social Security system just as they do now, with the same frequency. Their relationship to the process would not change. The Social Security system would administer the new system along lines similar to the Thrift Savings Plan that is enjoyed by so many of the people in this room.

Our proposal also provides true ownership and control over the proceeds from the personal accounts. Beneficiaries are required to annuitize a portion of their personal accounts, enough so that their traditional Social Security benefit and the personal account benefit together provide a monthly stream of income that is at least at the poverty level. But we provide flexibility regarding the use of remaining personal account balances. They can be passed on to heirs, they can be withdrawn in periodic cash payments, and through any of a number of other options, once the individual reaches retirement age. These are assets that would be owned and controlled by individual beneficiaries in a very real sense.

WHAT OUR PROPOSAL DOES NOT DO

Unveiling a proposal as comprehensive as ours invariably creates misunderstanding as to the effect of its various provisions.

First, let me address the impact of our reforms on the Consumer Price Index. Most economists agree that further reforms are necessary to correct measures of the Consumer Price Index, and our proposal would instruct BLS to make them. Correcting the CPI would have an effect on government outlays as well as revenues. This is not a "benefit cut" or a "tax increase," it is a correction. We would take what was incorrectly computed before and compute it correctly from now on. No one whose income stays steady in real terms would see a tax increase. No one's benefits would grow more slowly than the best available measure of inflation.

The proposal would instruct the BLS to make methodological reforms identified by the Boskin Commission, in the areas of "upper substitution bias" and "product quality improvement" that were identified and quantified in the Boskin Commission report. The estimate that we have put in our legislation, of a 0.5 percent change in CPI resulting from these reforms, is less than the estimate made by the Boskin Commission. Thus, we believe it is very unlikely that any "legislated" change in CPI would ultimately result from our legislation.

We wanted to be doubly certain that any effects of the CPI change upon Federal revenues not become a license for the government to spend these revenues on new ventures. Accordingly, we included a "CPI recapture" provision to ensure that any revenues generated by this reform be returned to taxpayers as Social Security benefits, rather than being used to finance new government spending. This is the reason for the "CPI recapture" provision in the legislation.

Our proposal would not increase taxes in any form. The sum total of the effects of all provisions in the legislation that might increase revenues are greatly exceeded by the effects of the legislation that would cut tax levels. The chart showing total cost rates makes this clear.

Our provision to re-index the wage cap is an important compromise between competing concerns. Fiscal conservatives are opposed to arbitrarily raising the cap on taxable wages. The case made from the left is that, left unchanged, the proportion of national wages subject to Social Security taxation would actually drop.

Our proposal found a neat bipartisan compromise between these competing concerns. It would maintain the current level of benefit taxation of 86 percent of total national wages. This would only have an effect on total revenues if the current-law formulation would have actually caused a decrease in tax levels. If total wages outside the wage cap grow in proportion to national wages currently subject to taxation, there would be no substantive effect. This proposal basically asks competing concerns in this debate to "put their money where their mouth is." If the concern is that we would otherwise have an indexing problem, this proposal would resolve it. If the concern is that we should not increase the proportion of total wages subject to taxation, this proposal meets that, too. I would further add that the figure we choose—86 percent—is the current-law level. Some proposals would raise this to 90 percent, citing the fact that at one point in history it did rise to 90 percent. The historical average has actually been closer to 84 percent, and we did not find the case for raising it to 90 percent to be persuasive. Keeping it at its current level of 86 percent is a reasonable bipartisan resolution of this issue.

CONCLUSION

Mr. Chairman, I thank you once again for using your position of leadership to advance debate on this important issue. I am appreciative that you were one of the first to come forward with a proposal that met the important standard of long-range actuarial solvency, and I appreciate your courtesies in inviting us to testify. I trust that you and the rest of this committee will look closely at the total effects of our plan in evaluating what it would achieve. I am confident that in doing so, you will find that it is a reasonable basis for hope that we can achieve a bipartisan agreement. I thank you again and would be pleased to answer any questions that you may have.

STATEMENT OF HON. JOHN B. BREAUX, A UNITED STATES SENATOR FROM THE STATE OF LOUISIANA

Senator BREAUX. Thank you, Mr. Chairman and members of the committee. You all are far away in distance, but I don't think we are that far away in ideas about how to solve this problem.

I think that my colleague Judd Gregg has accurately described the overall thrust of what is now known as the Gregg, Breaux, Grassley and Kerrey proposal. It is bipartisan. There are 15 other Senators that have joined together in a bipartisan fashion to present this to the Congress on our side over on the Senate side.

I think what you have done in this committee cannot be overstated in the sense that it is a major contribution. Just having Democrats working with Republicans on something as sensitive as Social Security is a major accomplishment in itself. We absolutely have to get away from looking at Social Security as a political football whereby one election Democrats blame Republicans for not fixing it, and Republicans blame Democrats for not doing anything. That type of rhetoric on both Medicare and Social Security has brought us to the point where nothing gets done.

I think we have a very unique opportunity and a small window of opportunity remaining of this year to actually come together with the surplus and the good economic times we are enjoying and doing some real structural reform to both Social Security and the Medicare program, and your committee over here in a bipartisan fashion is doing it. This is something Democrats can't do by ourselves, and Republicans can't do it by yourself. The only way it is going to get done is by working together. So enough said on the politics.

What we have is essentially—and I will describe two features of our plan which I think are some of the key parts of what we have recommended, and Judd has done an excellent job going through it all. The first thing is we create a 2 percent individual investment account. We require that everybody paying Social Security takes 2 percent of it and puts it into a private savings account, just like you have and all the other colleagues and all the people sitting behind you have the opportunity in the Federal Thrift Savings Plan to do.

They can put up to 10 percent of their money into a high-risk account, which is basically the stock market; they can put it into a moderate, medium type of risk, which is a combination of government bonds and the stock market; or they can choose the most safe investment of all is just put it in bonds. That is how this has worked for Federal retirees. It has worked very well, and what we have suggested is that Social Security beneficiaries and people paying the payroll tax ought to have the same opportunity to create wealth through an individual retirement account.

We don't put it all in there. We picked a number of 2 percent. Some say, why 2 percent? Well, why not? We didn't want to do it all and put it all into private accounts because that would have been too risky and totally privatize the program, which I would not support, and I think most Members would not. But we do say that 2 percent of your payroll tax would go into one of these three accounts. You pick. You decide. It would be managed by a group of professional managers much like we have for the Federal retirement plan that we are all underwrite now, and they do a good job. And we have taken your idea, Congressman, Nick, as far as how do you account for this.

I think in the Archer-Shaw plan, what they have done through the use of a claw-back, basically saying they create private accounts, but whatever you make in your private account is going to be deducted from what you would get under normal Social Security, so there is no real incentive, I would argue, to do this if you are going to lose it when you get your Social Security.

The way we pay for it is your idea, which you have introduced in legislation previously, to basically say that at the end of—a person's ready to be retired, you look at what they have made in the individual retirement account, and you look at what they would have made had they kept the money in Social Security, getting about a 3 percent rate of return, so if they put the money into this private account and they make 15 percent, just as an example, they wouldn't get the whole 15 percent, but they would get all of it minus what they would have got had they left it in Social Security. So had they left it in Social Security, maybe they would have made 3 percent. They put it into this private account, they got 15 percent. So you subtract the 3 percent from the 15. They still get a 12 percent advantage, which is very, very significant.

And they own the account. They can inherent their account. It connects people with the concept of investing for their own future. It makes young people more in tune to what Social Security is trying to do for them. It affects no one who is 62 years of age or older. You can go to AARP and all the other groups and tell them we are talking about baby boomers and those in my category, making some changes for us that is going to give us a better opportunity to retire successfully. That is the first part, the 2 percent.

The second part is really aimed at doing more for lower-income people, and you have—I think my staff put out a little chart about the voluntary contributions. It is this chart right here. And this is in addition to the 2 percent investment account. This says that we are going to help low-income people do a little bit more than other than their 2 percent. So an example, a person with a 20,000 and a $30,000 salary, if the person with the $20,000 salary takes the 2 percent and puts it—that is 2 percent of 20,000 is $400 a year they would have in their individual retirement account. If they want to do more and they put up another $1, the government would match that with an extra $100, giving that person 400 plus the $101, for a total of $501 that that person could put in their individual retirement account, and then the person could continue to contribute up to 1 percent up to the amount that they would reach as the taxable income base, which is about $72,000 today. That person could contribute an additional 112, so he would have $725 additional in their account that they would be able to do.

The same pattern for the person making the 30,000. The only difference is that when they put 2 percent of their 30-, obviously it is $600, if you put another $1, the government would match it with 100. That would give you 701. You only need 12 dollars more to get up to the maximum amount. This is extra and voluntary, but it strengthens the whole opportunity to increase wealth for the individuals.

And I would just say that—I mean, we ought to seize the opportunity to do something. They have got a lot of variations about all of this, as many economists as you can think of that come up with schemes and plans and recommendations that they think would work. But we think the 2 percent account plus the voluntary contributions with no tax increase and no age increase for seniors. Retire at 62 years of age and gradually work up to 67. We do have a CPI adjustment, which everybody has recommended that we do, and that is our plan.

Thank you.

Chairman SMITH. Senator Grassley, welcome. I said good things about everybody that was brave enough to proceed, so congratulations, and please go ahead.

STATEMENT OF HON. CHARLES E. GRASSLEY, A UNITED STATES SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Well, I can listen a long time if you have some more things you want to repeat.

Thank you very much for the opportunity to be here with you. I am going to just focus my remarks on a very narrow area of our whole program of what we do to improve the situation for workers who are in and out of the work force. For the most part women, it is who are in and out of the work force, and probably more apt to be that because of family responsibilities that in our society tend to rest more on women than on men, right or wrong.

But before I do that, if I could just comment on the statement that Senator Breaux started out with on the bipartisanship. Let me emphasize from a historical perspective backing up what he said. I think Social Security, being the social contract that it has been for 63 years, has never been dramatically changed without bipartisan cooperation. And, I don't think it will be again this year, and probably we can suggest the changes that change somewhat the basic format, albeit it is still a social contract. That social contract has changed to some extent, all the more reason to have bipartisan support.

So my colleagues have thoroughly outlined our proposal. I would like to highlight just a few aspects. In designing our plan, we assessed how changes to Social Security would affect different segments of the American population. One of my top priorities in reforming Social Security is ensuring that the program addresses needs of women. This is how our bipartisan program would do that:

Women are more likely to be in and out of the work force to care for children and elderly parents. We believe that they should not be punished for the time that they dedicate to dependents. Therefore, for every two-earner couple our plan provides 5 dropout years to the spouse with lower earnings. Our proposal provides all workers with an opportunity to create wealth by contributing to their individual account, an amount equal to 1 percent of the taxable wage base. This year that figure would be $726. Workers whose combined 2 percent contributions equal less than 1 percent of the taxable wage base would receive $100 from the Federal Government when they put in the first dollar of savings. They would then receive a dollar-for-dollar match by the government for additional contributions up to 1 percent of the wage base. This progressive feature will boost the contributions for low-income individuals, many of whom, happen to be women.

Also, our proposal creates an additional bend-point to benefit formula to increase the replacement rate for low-income workers. Women live longer than men. So at age 65 men are expected to live

15 more years, whereas women, the case happens to be 20 years. Our proposal addresses that reality by allowing money accumulated in individual accounts to be passed on to surviving spouses and children.

Furthermore, our proposal would increase the widow's benefit to 75 percent of the combined benefit that a husband and wife would be entitled to based on their own earnings.

As many older Americans live longer, healthier lives, they are eager to remain in the work force in various capacities. Others remain in the work force out of necessity. We would eliminate the earnings test for beneficiaries 62 and older so that retirees may continue to contribute to the economy without being penalized. Currently, benefits are reduced for over 1 million beneficiaries because their wages exceed the Social Security earnings limit.

Furthermore, our proposal would correct the actuarial adjustment for early and late retirement. Currently, individuals do not receive back the value of payroll taxes contributed if they delay retirement. Our plan increases both the early and delayed retirement adjustments to levels appropriate to recognize additional tax contributions. Retirees who remain in the work force could also contribute to their individual accounts.

The first step on the road to reforming Social Security is to engage the American public in the policy debate. No action could take place without Americans making informed decisions about how to design Social Security for their needs of the 21st century. Now, America, after doing that for a year, seems to me to be ready for reform. According to a recent poll conducted by Americans Discuss Social Security, and I had the pleasure of serving with Senator Moynihan as cochair of that group, we have our survey showing 58 percent of those surveyed believe reform should take place before the 2000 election.

The second step in saving Social Security was to address its long-range funding difficulties. Several proposals have now been put forward that would do this. Now, we must work together in the next step, and that is enacting Social Security—or legislation to restore the long-term solvency of Social Security.

I want to stress the importance of saving Social Security sooner rather than later. Do we work now to prepare for the retirement of the baby boom and subsequent generations, or do we sit back and leave the legacy of higher taxes and unmet benefit obligations? According to Social Security actuaries, in the year upon 2075, and that is the last year of our 75-year valuation period, income to Social Security program will be $14 trillion, but we will owe $21 trillion in benefits. It is obvious you can't take more hay out of the barn than you put in. So plain and simple, that translates into more Draconian measures that we will be forced to take for each year that we fail to enact legislation to protect the program that most older Americans rely upon and almost every pension system uses as a basis, as a foundation.

Thank you.

[The information referred to follows:]

PREPARED STATEMENT OF HON. CHUCK GRASSLEY, A UNITED STATES SENATOR FROM THE STATE OF IOWA

Thank you, Chairman Smith. I am pleased to be here today with my colleagues to discuss our proposal to save Social Security. I want to commend you for holding this hearing. It is an important step in reforming Social Security.

My colleagues have thoroughly outlined our proposal. I would like to highlight a few aspects. In designing our plan, we assessed how changes to Social Security would affect different segments of the American population. One of my top priorities in reforming Social Security is to ensure that the program addresses the needs of women. Let me explain how the Bipartisan Reform plan accomplishes that goal:

Women are more likely to move in and out of the work force to care for children or elderly parents. We believe they should not be punished for the time that they dedicate to dependents. Therefore, for every two-earner couple, our plan provides five "drop out" years to the spouse with lower earnings.

Women, on average, earn less than men. Our proposal provides all workers with an opportunity to create wealth by contributing to their individual accounts an amount equal to 1 percent of the taxable wage base. For this year, that would be $726.

Workers whose combined 2 percent contributions equal less than 1 percent of the taxable wage base would receive $100 from the Federal Government when they put in the first dollar of savings. They would then receive a dollar-for-dollar match by the government for additional contributions up to 1 percent of the wage base. This progressive feature will boost the contributions for low-income individuals, many of whom are women.

Also, our proposal creates an additional bend point to the benefit formula to boost the replacement rate for low-income workers.

Women live longer than men. At age 65, men are expected to live 15 more years, whereas women are expected to live almost 20 more. Our proposal addresses that reality by allowing money accumulated in individual accounts to be passed on to surviving spouses and children.

Furthermore, our proposal would increase the widow's benefit to 75 percent of the combined benefits that a husband and wife would be entitled to based on their own earnings.

As many older Americans live longer, healthier lives, they are eager to remain in the work force in various capacities. Others remain in the work force out of necessity.

We would eliminate the earnings test for beneficiaries age 62 and older so that retirees may continue to contribute to the economy without being penalized. Currently, benefits are reduced for over one million beneficiaries because their wages exceed the Social Security earnings limit.

Our proposal would also correct the actuarial adjustment for early and late retirement. Currently, individuals do not receive back the value of payroll taxes contributed if they delay retirement.

Our plan increases both the early and delayed retirement adjustments to levels appropriate to recognize additional tax contributions. Retirees who remain in the work force could also contribute to their individual accounts.

The first step on the road to reforming Social Security was to engage the American public in the policy debate. No action could take place without Americans making informed decisions about how to design a Social Security program which would meet their needs in the 21st Century.

Now, America is ready for reform. According to recent poll results from Americans Discuss Social Security, 58 percent of those surveyed feel that reform should take place before the 2000 elections.

The second step in saving Social Security was to address its long-range funding difficulties. Several proposals have been put forward to save Social Security. Now we must work toward the next step: enacting legislation to restore the long-term solvency of Social Security.

I must stress the importance of saving Social Security sooner rather than later. Do we work now to prepare for the retirement of the baby boom and subsequent generations, or do we sit back and leave a legacy of higher taxes and unmet benefit obligations?

According to Social Security's actuaries, in 2075—the last year of the 75-year valuation period—income to the Social Security program will be $14 trillion, but it will owe $21 trillion in benefits. You can't take more hay out of the barn than you put in. Plain and simple, that translates into more Draconian measures that we will be forced to take for each year that we don't enact legislation to protect the program on which so many older Americans rely.

Thank you for the opportunity to outline our proposal. We would be happy to entertain any questions you might have.

Chairman SMITH. Gentlemen, again my compliments. So many details in your proposal have been thought out and addressed. And I want to say something really positive because I would like the opportunity to ask some tough questions. One is on the CPI adjustment, because that also affects the ultimate increase in income taxes because of bracket creep and because of lower deductibles.

Senator Gregg, so it is going to have the effect of increasing those taxes? How are taxes ultimately going to be decreased? I don't understand that.

Senator GREGG. Well, because if you look at current law, the increase in taxes that would be required to fund the benefit is dramatic. It is about 4 percent, 4.5 percent difference from where we are today. If you look at the Archer plan in the year 2030, I believe the difference between our plan and the Archer plan is about 2 percent of general tax revenues.

So, the CPI increase is significantly less. It is 0.78 percent as versus 2 percent or 4.7 percent on the present law as being the difference between the increased tax burden if you don't accomplish our plan as versus if you do take our plan.

So I think you have to look at net taxes. You can't just look at one tax and say that goes up a little, therefore there is a tax increase. I think you have to look at the effect on the net tax burden. Under the net tax burden, under our bill, taxes are significantly reduced over any other bill that is out there with the exception possibly of yours.

Furthermore, the extent that the CPI does generate new tax revenues in our bill, we don't let that go into the general fund. We put it into the benefit structure to assist in paying Social Security benefits. So we don't allow it to be used; any bracket creep that may occur as a result of indexing the tax tables to CPI, we don't allow that to flow into the general revenues. We cause it to flow into Social Security Trust Fund, and so it benefits the Social Security System and does not end up being spent on other activities.

Chairman SMITH. Chairman Greenspan and Secretary Summers in testifying before this Task Force suggested that whatever plan is adopted, it needs to encourage additional savings, investment. Senator Grassley, you sort of suggested that your plan allows a 1-percent add on. How else do you encourage savings investment? How does that work?

Senator GRASSLEY. Well, don't forget, if people have been in the work force and have an individual account, that is earning growth while they are outside the work force. So that is one way that we enhance that opportunity. It seems to me another very fair way is that the opportunity to pass that on as part of your estate as well as being quite an incentive to do this, equalizing of benefits for low-income families. Spouses who are in and out of the work force, may be dying early, the family is losing benefit of that. There is some of that growth that comes to the benefit of the family that way.

So the most important point is that it has growth when people are not in the work force.

Chairman SMITH. A couple of the economists suggested to the Task Force that if you are going to replace the Social Security and not touch the disability portion, you need 5.4 percent of taxable payroll as a separate investment, assuming a 7 percent real rate of return. Did you consider, and if so, why you decided against increasing it over 2 percent?

Senator BREAUX. Really, what we have is a compromise between those who would make it a lot larger. Ours in the Federal plan is a 10 percent plan. I mean, that is more than I think is doable at this stage in the political forum. I think 2 percent is a major step in creating individual accounts, but it could be more. I mean, anything less becomes almost insignificant in a sense of making a difference. We cited that 2 percent was about the right figure and then added the voluntary contributions for the lower-income people, which I think is significant. It is going to really get them down the path of starting to save, knowing that the government is going to match their first dollar with $100 and a 1-to-1 match up to the taxable base. You have help for lower income people and a real incentive for the regular people to put the 2 percent in there, but that is a number that—any number you pick is going to be arbitrary to a certain extent.

Senator GREGG. That number is also controlled by actuarial solvency.

Senator BREAUX. That is what we needed.

Senator GREGG. If we could have afforded more, we would have put more.

Chairman SMITH. Thank you.

Congressman Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. And let me thank you all for testifying today and also for putting together a fairly broad and specific plan, which has not always been the case with some who have testified before this panel.

First off, have you—has your plan been scored?

Senator GREGG. Yes, it has been scored by the actuarial trustees of the Social Security Administration as creating solvency perpetually, twice.

Mr. BENTSEN. And has it been scored by—I mean, if I read the summary correctly, there are a number of new tax provisions, some savings enhancements beyond the 2 percent, which I assume are pretax. I am not sure. Have those been scored by either Joint Tax or CBO?

Senator GREGG. They are after tax, and they have not been scored by Joint Tax or CBO.

Mr. BENTSEN. Okay. And has any analysis been done that would give you an idea of how various income groups would be affected under this new formula going out over the next 75 years?

Senator GREGG. Yes. We have extensive analysis on that, and we would be happy to get them to you. And I would just tell you that what it is going to show, that low- and moderate-income groups do extremely well as compared with present law or the President's proposal.

Mr. BENTSEN. I would be interested in seeing that. And again, the investment requirement—or the investment requirement is similar to the Federal Thrift Savings Plan. There is a limitation on what it can be invested in; is that correct?

Senator GREGG. That is correct. You get a choice.

Mr. BENTSEN. Pooled funds or whatever.

Senator GREGG. It will probably be index funds initially.

Mr. BENTSEN. A couple of specific questions. Initially you have the claw-back provision, which, if I understand that correctly, you take the spread between the T-bill—the annual T-bill rate and the return on the private account and——

Senator GREGG. There is no claw-back provision. Basically what we do is reduce the benefit structure by what the T-bill rate would be on the amount of the personal account. You own the personal account. Whatever is in there, you get; it is yours, it is your asset. But your benefit under Social Security would be reduced by—let's say you put in 2 percent every year. It would be 2 percent plus the rate of return of the T-bills, which would be about 3 percent, so your benefit structure would be reduced by that amount, but you actually own the asset. In addition, you don't have to credit back to the Federal Government an amount of the money. You own the physical asset, and to the extent you have exceeded that T-bill rate, you have made money.

Senator BREAUX. I want to make sure that we all understand. It sounds complicated when we are talking about how do you pay for the 2 percent, and it is not really that complicated. I mean, if you have your private account, and say you average 15 percent return investing it in the various private accounts, and you have got a 15 percent rate of return, what our plan suggests is that what you do when you start collecting your Social Security is to reduce your Social Security by what amount would have been credited to your Social Security had you taken the 2 percent, and instead of putting it in the private account, just kept it in Social Security, like Judd said, that you would have gotten a 3 percent return, then you reduce it by 3 percent. So instead of getting 15 percent increase in your retirement, you would have it reduced by about 3 percent.

Mr. BENTSEN. But, Senator, the reduction applies to the defined benefit portion, the remaining 10 percent or whatever at the annualized T-bill rate, so your only risk there—I mean, generally you should have a positive spread. Your only risk is if the market underperforms.

Senator GREGG. Underperforms the T-bill rate.

Mr. BENTSEN. Which in rare occasions happens.

Senator BREAUX. Not over a 20-year period, it has never had a negative return over the T-bill rate, which is the time which most people would be paying into a retirement account.

Mr. BENTSEN. The KidSave portion is outside of Social Security. This is just a new program, although you could roll it into your private account. How would that be funded, just through general revenues?

Senator BREAUX. That is correct.

Senator GREGG. That is correct.

Mr. BENTSEN. So that would be scored.

I have two other quick questions. One is you recapture Social Security revenues currently diverted to the Hospital Trust Fund. I understand that. What I am concerned about is do you make any proposals for replacing the revenue taken out of the Hospital Trust Fund in Medicare?

Senator BREAUX. The President will announce that at 2:30 this afternoon. No, I mean the basic premise is the fact that Social Security revenues ought to be for Social Security. And, you know, we did it when Social Security was in good shape by kicking it into Medicare to kind of help Medicare, but now Social Security needs what Social Security is entitled to, and we put it back where it is, recognizing that the Medicare problem is a legitimate problem and has to be fixed. But this relatively small amount is not what is needed to fix Medicare, so it should be kept for Social Security beneficiaries.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman SMITH. Congressman Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Gentlemen, if I believe I understand that, you are doing a 2 percent carve-out rather than 2 percent additional; is that true?

Senator BREAUX. Yes.

Mr. COLLINS. Two percent required.

Senator GREGG. It is required.

Mr. COLLINS. On the voluntary contribution portion of it, what is the top annual salary that a person qualifies or is disqualified beyond to participate in the voluntary provision?

Senator BREAUX. It is approximately 35,000 is what the staff is telling us. You can raise it or lower it, obviously, but we thought 35,000 was about the maximum that we would be able to do it.

Mr. COLLINS. What would be the maximum benefit of a $35,000 wage-earner contributing voluntarily?

Senator BREAUX. Seven hundred twenty-five, I think. Mac, you have that little chart right here. I mean, the voluntary contribution allows you to get up to 1 percent of the taxable wage rate, which ends up at about $707 each year, so the amount that the contribution is made available is reduced each year until you get to the total of 725.

Mr. COLLINS. And the maximum general funds that would be used to match, 725 also?

Senator BREAUX. That is correct.

Senator GREGG. Wouldn't match 725. Maximum amount of the match would be 112.

Mr. COLLINS. The individual is less than the general fund match by $99; is that true? Let me ask you.

Senator GREGG. Reduce the 725 by the mandatory contribution to get to the number that you would then be able to put a dollar in, the Federal match would be $100 that would come out of the general fund.

Senator BREAUX. I don't know if you have that little chart that we gave with the 20,000 and the 30,000. You see what the private consideration would be under 20,000 and then under the 30,000. The max goes to $725, regardless of income. You couldn't go more than that.

Mr. COLLINS. Is there any provision that allows a wage-earner above 35,000 to opt not to have their tax dollars used for this purpose?

Senator GREGG. No.

Senator BREAUX. Obviously the 2 percent contribution, obviously that portion of that is 2 percent, not a significant amount.

Mr. COLLINS. You are setting up a program where you are going to take funds from another taxpayer and deposit them into an account for another taxpayer, up to 35,000. And above that is where you are actually taking your funds from; is that the way I read this? That would be the entitlement to the ones that would owe 35,000. It is voluntary, but you are taking money from above 35- to contribute to their account? But there is no volunteer opt-out for someone from 35,001 to 75,000 or 80,000 to not participate in that program? They just have to ante up?

Senator GREGG. Their 2 percent would get them to that 725.

Mr. COLLINS. We are above that. We are talking about the voluntary portion.

Senator GREGG. That would be funded from the general fund.

Mr. COLLINS. You put money in, but you also have another taxpayer putting it in for you.

Senator GREGG. It would come out of the general fund.

Mr. COLLINS. There is no voluntary provision for the other taxpayer, just the one that wants to contribute?

Senator GREGG. Right. This is the progressive part of this plan. That is correct.

Mr. COLLINS. That is all I have. Thank you.

Chairman SMITH. Mr. Toomey.

Mr. TOOMEY. I would just like to—two quick questions. One is to understand the nature of the taxable wage base. I am a little bit confused. There is a reference to the CPI that adjusts the tax revenue side. And elsewhere in the little summary I have here it says that the taxable wage base is maintained at 86 percent of total wages, as we all know; currently the taxable wage base is a fixed number. Is it your intention that this grows? And if so, how does that work?

Senator BREAUX. Well, right now it is about 86 percent. Under current law taxes only go up to 72,600. That level is about 86 percent of all wages in the country are taxed. Because wages are going up, that amount is being reduced, obviously. And what we are suggesting is that you maintained the 86 percent of the wages being subject to Social Security taxes, therefore you would have wages continue to go up. You would have an increase in account.

Mr. TOOMEY. So that would be a significant tax increase for many earners, certainly for people who are above that cap.

Senator GRASSLEY. Same as it is now.

Senator BREAUX. It is 86 percent today, and it would be 86 percent next year if wages go up. The number goes up.

Senator GRASSLEY. It is a significant increase in taxes, but not any more than you have under present law. It would be fair to say it is present law.

Senator BREAUX. Yes, it is 86 percent.

Mr. TOOMEY. The other question that I have, point number 4 of the summary that you sent around refers to giving every child a retirement savings account. This is funded by the government putting in $1,000 into this account at birth, and then the government puts in another $500 every year for the next several years. Is that the way that would be funded?

Senator BREAUX. That is the KidSave account, and that is an idea that was crafted by Senator Bob Kerrey, and that is the way it would work.

Senator GREGG. We wish he were here to explain it. It is a good idea. The basic concept is to create a huge savings pool which people would then have available to them.

Mr. TOOMEY. How do you respond to the idea that this is a whole new entitlement and we are sending a message that everybody has a birthright to getting a large check without having done anything at all to earn it?

Senator GREGG. Of course Social Security could be viewed in that way, too, to some degree. The fact is that we are basically saying that the society should address the Social Security insolvency issue in the later years of the next century by prefunding the liability as versus having it be a contingent liability. That is what this all comes down to. The whole debate over Social Security is a debate over whether you are going to create a huge tax burden for the next generation by running up an obligation which the next generation has to bear in order to support the retired generation before it, or whether the generation that is going to retire creates an asset which can be used to reduce their retirement benefit needs. And so what this is is basically carrying that concept one step further, which is initiating the prefunding of the next generation of liabilities.

Senator GRASSLEY. And it seems to me if you want to deemphasize the plague that you might call the entitlement mentality that we have in our economy and society today, one of the ways that you do that is to create ownership and have people have a stake early on in their retirement and feel a part of the system. And you might say, well, the $1,000 is given, that is not part of the system, but the ownership that comes with it, more importantly the economic growth that comes from it, is something that is theirs. And that is very important if you want to have reduced generational gaps that we have in our system or conflict as well as promote a concept of people having growth so that they feel a part of the economy, particularly lower-income people that feel left out today.

Senator GREGG. It makes everybody a capitalist at birth.

Mr. TOOMEY. Thank you.

Mr. RYAN. I was going to go on another line of questioning, but I would like to expand on the KidSave accounts. Thank you for coming, by the way. It is good to have you here.

The KidSave account, what is the score on the KidSave account? This is a government contribution of $1,000 and then a government contribution of $500 for 5 years after that for a total of $3,500. What is the score of that, and is that an indexed amount?

Senator BREAUX. Staff tells us that it is $14 billion a year.

Mr. RYAN. Is that indexed?

Senator BREAUX. It is indexed.

Senator GRASSLEY. Remember that is paid for in the projection of our system.

Mr. RYAN. And the cost savings primarily from your system come from the CPI change and the fact that you reduce the defined benefit base by the bond indexed amount taken off outside of your 2 percent individual account?

Senator BREAUX. That is how you pay for the 2 percent.

Mr. RYAN. That is basically the funding mechanism.

Senator BREAUX. That is right.

Mr. RYAN. And the actuaries have scored the long-term solvency of this account with the KidSave taken into account?

Senator GRASSLEY. For 75 years.

Mr. RYAN. And it is 14 billion a year, and that obviously goes up with the indexation; correct? Now every single child born gets the KidSave account? There are no other strings? You get a Social Security number, and $1,000 and $2,500 after that, and then you can roll your KidSave account into your Social Security account after that period?

Senator GREGG. When you turn 18.

Mr. RYAN. When you turn 18, you roll it in.

Can you make contributions into this KidSave account other than the money that you received from the government?

Senator BREAUX. You cannot add to it, but when you roll it over into your Social Security account, you can add to the account at that time.

Mr. RYAN. As you could with the other Social Security rollover provisions.

That is all for me. Thank you.

Mr. BENTSEN. Will the gentleman yield?

The KidSave account, though, that is not coming from proceeds from Social Security, the payroll tax. That is general revenues monies that are appropriated. Okay.

Chairman SMITH. Gentlemen, I am going to take the liberty of asking you one last question. If you were betting, what do you consider the odds of something coming out of the Senate?

Senator GREGG. I will defer that to my finance fellows.

Senator BREAUX. The Finance Committee—Senator Grassley and I both serve on it—I think the odds of doing something on this and Medicare, I think, are better than 50-50 in the sense that you have a bipartisan type of arrangement going where you have Members on both sides that have joined together in a common proposal. And I think that is very significant. It is not just your plan or your plan, it is one Republican-Democratic plan together. And I think that has greatly increased the odds of having something come out of the Finance Committee and go to the floor of the Senate which I think would pass.

Chairman SMITH. Congressman Herger.

Mr. HERGER. Thank you, Mr. Chairman.

I want to thank each of you for the monumental work that you are doing in the Senate on coming up with a bipartisan plan. I find it sad and disheartening that the President could not have given more support, at least a little bit of support, so that we could have moved this process forward a little more than what it has. But that is not to say that we are not going to be successful. We have to be successful. I am convinced the only way we are going to solve this monumental problem is that we work together, the Senate, the House, the President, Republicans, Democrats, quote, liberals, conservatives, everyone working together. This is a challenge that faces each and every American, certainly not one class or another. So I want to thank you for this work that each of you has done.

I really don't have any more questions. I would like to urge you, though, as we have what I feel was the first step, and that was the lockbox proposal, which did pass out of the House by an overwhelming vote 412 to 16. I understand there will be another cloture vote perhaps on Thursday. I think essential as the first step that at least we lock up those dollars that have been paid to Social Security and the interest on it not be used for anything else. And I would certainly urge each of you that we move forward with that as well as areas that you are working on.

Senator GREGG. You have 60 percent of this panel for it.

Chairman SMITH. Gentlemen, thank you very much. Any final closing statements? It is such a good opportunity for us to lecture Senators, so thank you again.

Representative Clay Shaw on the Shaw-Archer proposal. And Chairman Archer. Bill, I didn't see you. Chairman Archer, just give us 1 second—that was 17 Senate staff that apparently just left.

Chairman Archer, Representative Shaw, welcome. Thank you for being here. Please proceed.

STATEMENT OF HON. BILL ARCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. ARCHER. Thank you, Mr. Chairman. I will attempt to shorten my oral testimony, and without objection I hope my full statement can be entered into the record.

Chairman SMITH. Yes it will be. All full statements will be in the record without objection.

Mr. ARCHER. Mr. Chairman, as you have said, we have an historic opportunity this year to save Social Security. If we do not do it, it becomes exceedingly more difficult in every new Congress.

We should act now, and our greatest opportunity to do it will be on a bipartisan basis. And to that end, I have been working with the White House and with the Democrat leadership in the House to see if we can come to some resolution that both sides—or all sides, I should say, can support. Without that, it becomes far more difficult. It becomes simply a partisan activity.

For many months, Congressman Shaw and I have been developing a plan that we believe can be passed that will save Social Security for all time. It has been certified by the actuaries at SSA that it will save Social Security for 75 years and get even better in the years beyond that.

We do not raise taxes. We do not cut benefits. We maintain the safety net for workers, and we provide new options for younger workers.

Let me say, Mr. Chairman, that as I have worked with Social Security over the many years that I have been in the Congress, I have over and over again said that it must be intergenerationally fair, and we have an opportunity to make it so. If we grant benefits to today's seniors that are not available to the next generation or the generation beyond that, it is not intergenerationally fair. And that is one reason why I have a great deal of difficulty in justifying cuts in benefits.

If we increase taxes on the next generation and the generation beyond above what this generation is paying, it is not intergenerationally fair. So that is why Congressman Shaw and I came together with no cuts in benefits, don't touch the existing Social Security System, and no increases in taxes. In fact, our plan, when implemented over the long term, will generate a unified budget surplus, which your committee is particularly interested in, of $122 trillion. That is a great benefit to future generations.

Now, how does it work? Very simply, 2 percent of payroll is computed at the end of each year on every worker that qualifies for Social Security, and they receive a refundable tax credit equal to that amount of money out of the general Treasury. It is a tax reduction dollar for dollar which goes into personal savings. That money is transferred into a personal savings account, what we call a Guaranteed Social Security Account, for each worker, directly from the Treasury, and that worker thereafter determines where that money is to be invested.

I think all of the plans that you look at have some degree of government standards as to what qualifies as a legitimate investment, and that is a part of our plan.

Should you die before reaching retirement, the money that is left in your plan after providing for your widow and any survivors is yours to will to any beneficiary that you see fit. You are not obligated to retire at any particular time, but when you do retire, your account is converted into an annuity, and that annuity guarantees you a certain amount of money based on life expectancy for the rest of your life. If that amount is not enough to equal the Social Security benefit under the current system—and bear in mind we don't change the benefits compared to what people are getting today, the next generation and the generation following and the generation after that gets the same benefit—if your personal account is not enough to equal that benefit, then the Social Security Administration makes up the difference. So it keeps the safety net for workers.

We, by the way, do not touch the disability program. That needs looked at very carefully, but we see that as a separate action on the part of the Congress.

So, Mr. Chairman, I appreciate the opportunity to come before you. There is more that I am sure will be developed in the question-and-answer period, and I have, I think, come close to complying with my 5-minute limitation.

Chairman SMITH. I am not sure. Either I was very interested, or that 5 minutes went very quickly.

[The prepared statement of Mr. Archer follows:]

PREPARED STATEMENT OF HON. BILL ARCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, AND HON. CLAY SHAW, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Preserving Social Security for the future is one of the most challenging and most important tasks we will undertake as Members of Congress. Fortunately, a strong economy and a promising budget outlook give us an unprecedented opportunity to address Social Security's long-term fiscal crisis.

We are seizing this opportunity by offering a proposal to save Social Security. Our proposal, the Social Security Guarantee Plan, does not seek to radically alter the Social Security program or change the nature of Social Security benefits. Instead, the plan fully maintains the current program, but reforms the way benefits are financed, making the program affordable and sustainable for future generations.

GUIDING PRINCIPLES

Five main principles guided the design of the Social Security Guarantee Plan.

1. Fully guarantee current Social Security benefits for life. According to data from the Census Bureau, Social Security benefits alone reduce the elderly poverty rate from 48 percent to 12 percent. If Social Security benefits are cut, many elderly Americans will be pushed into poverty, forcing them to rely on other government programs. Consequently, our plan does not cut benefits for anyone, and it does not change the defined benefit nature of the program.

2. Ensure fairness for all generations. Saving Social Security should not place an unfair burden on young and future workers by forcing them to pay higher taxes or settle for lower benefits. At the same time, imposing changes on current retirees and those nearing retirement would be unfair because these beneficiaries and workers will not have adequate time to prepare for the changes. Our plan guarantees current law benefits without payroll tax hikes, eliminates the earnings limit that penalizes many working seniors, and reduces the payroll tax in the long run.

3. Save Social Security forever. Any plan to save Social Security should save the program for at least 75 years, the standard used by Social Security's actuaries because it includes the working and retirement life spans of most workers. Moreover, the plan should make the Social Security program sustainable so we are not faced with a cliff at the end of 75 years. In other words, at the end of 75 years, Trust Fund balances should not be declining and the program's cash shortfalls should not be increasing. Only by making Social Security stable in the future can we avoid the need to constantly tinker with payroll taxes and benefits to keep the program solvent.

4. Promote fiscal responsibility. Any plan to save Social Security must be fiscally responsible. Our plan directly increases national savings, thus generating economic growth, higher wages, and better living standards. Moreover, our plan pays for itself in the long run and generates large surpluses in the unified budget. These savings allow us to cut the payroll tax for the first time in the program's history. This is true even under the most conservative budgetary assumptions.

5. Ensure political feasibility. Finally, our plan is designed to be politically feasible. Realizing that Social Security reform cannot happen without bipartisan support, we are offering a plan that builds on areas of bipartisan consensus and bridges the gaps between ideological differences. The plan fully maintains the current safety net and fully shields individuals and their benefits from market risk. However, it creates individual accounts so that benefits can be funded in advance with real savings.

HOW THE GUARANTEE PLAN WORKS

Any plan to save Social Security should be simple and transparent so that workers can easily understand how the program is changing and how their retirement income will be affected. The Social Security Guarantee Plan is simple, transparent, and easily understandable. The plan can be described in four steps.

1. Annual Tax Credit. All workers would receive a refundable tax rebate equal to 2 percent of their Social Security taxable wages earned in 1999 and thereafter. (The maximum credit in 1999 would be $1,452, increasing annually with average wage growth.) The credit would be financed with general revenues so that no payroll taxes are diverted from the current system. Proceeds from the tax rebate will be automatically deposited into a Guarantee Account established in each worker's name.

2. Designation of Savings Options. Workers would choose one of several pre-approved investment options that meet safety and soundness guidelines. The funds would be required to invest their assets in a fixed mix of 60 percent equity index funds and 40 percent fixed income funds. This portfolio provides a stable trade off between risk and return and reduces the educational requirements of the program. Workers who do not choose a savings option will be assigned to a comparable fund.

Earnings would accrue tax free, thus increasing the compounding power of the accounts. Accounts could not be accessed or borrowed against for any reason prior to benefit entitlement.

3. Annuity Calculation. Upon retirement, the Social Security Administration would calculate a monthly pay out based on the account balances. This calculation would be similar to an annuity calculation, accounting for life expectancy (based on unisex mortality tables), expected inflation, expected returns on the account (which would continue to be invested privately), and joint/survivor payments.

The worker's monthly benefit would equal the current law benefit or the calculated monthly pay out, whichever is higher. Each month, the monthly pay out would be transferred from the account to the Social Security Trust Funds to help finance the worker's benefit, and the worker would receive a single check for their entire benefit. Workers who outlive their account balances would continue receiving full monthly benefits financed from the Social Security Trust Funds. In essence, workers accumulate savings during their careers to help finance their Social Security benefits, which otherwise would not be payable under current law. This design allows us to guarantee current law benefits and shield workers from market risk.

4. Inheritance. If workers die prior to collecting benefits, the account is maintained to support survivor benefits. If there are no aged survivors, remaining account balances can be bequeathed to heirs tax free. In contrast, if the worker dies after collecting benefits, any remaining balances are transferred to the Trust Funds to help pay benefits for those who outlive their account balances. This is the way private annuities work.

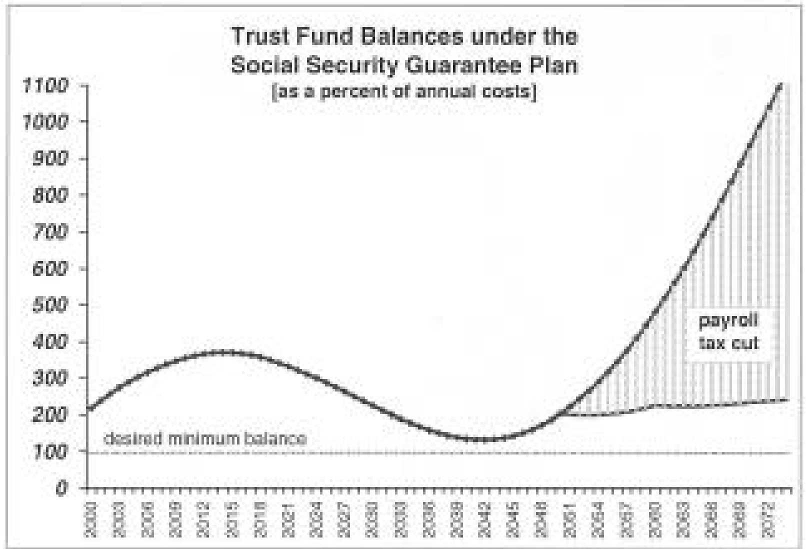
The plan also creates some new benefits for both current and future retirees. The plan would eliminate the earnings limit for all beneficiaries age 62 and over by the year 2006. (Currently, the earnings limit reduces Social Security benefits for approximately 1.4 million retirees.) In addition, the plan would reduce the payroll tax rate from 12.4 percent to 9.9 in 2050. The tax rate would be further reduced to 8.9 percent by 2060.

HOW DOES THE GUARANTEE PLAN SAVE SOCIAL SECURITY?

Social Security is facing a financing problem: the pay-as-you-go method of financing benefits is not sustainable because the population is aging. As the population ages, there will be fewer workers to finance the benefits of each retiree, placing more and more pressure on the future work force.

The Guarantee Plan alleviates this financing problem by updating the program's Depression-era, pay-as-you-go financing mechanism. The plan uses general revenues to finance individual accounts. The savings that accumulate in these accounts are used to help finance future benefits. In other words, the plan creates a savings feature within Social Security so that worker's can save for their own retirements instead of relying on future taxpayers. This pre-funding of benefits reduces Social Security's unfunded liabilities and reduces the program's annual costs. As a result, Social Security surpluses reemerge. These surpluses allow us to reduce the payroll tax rate from 12.4 percent to 8.9 percent by 2060. If these surpluses are not returned to workers, they will accumulate in government coffers where they will undoubtedly be used to finance new spending initiatives.

According to Social Security's actuaries, our plan reduces Social Security's costs, generates Social Security surpluses, allows future payroll tax reductions, and saves the program beyond 75 years. Most importantly, the plan eliminates the cliff effect. In other words, the program's financing is sustainable in the long run with healthy cash flows and growing Trust Fund balances. Thus, the program does not fall off a cliff in the 76th year (see graph).



BUDGETARY EFFECTS OF THE GUARANTEE PLAN

Social Security has been running annual surpluses since the early 1980's. These surpluses have been used to finance deficits in the rest of the government, thus improving the unified budget. This situation will quickly reverse itself early in the next century. According to Social Security's Trustees, program costs will exceed income beginning in 2014, and the Treasury will have to come up with the cash needed to draw down the Trust Funds. Between 2014 and 2034 (when the Trust Funds are depleted), these cash shortfalls will total $7.5 trillion, placing a large strain on the Federal budget. Unless the government defaults on future promised benefits, the Treasury will have to come up with another $106 trillion to pay benefits for the remainder of the 75-year period.

As explained earlier, the Social Security Guarantee Plan uses general revenues to finance individual accounts. Account balances are used to pre-fund Social Security benefits, thus reducing the program's future unfunded liabilities. In sum, the plan increases General Fund costs, but reduces Social Security costs. Over time, the savings to Social Security will outweigh the cost of financing the accounts, thus generating unified budget surpluses.

According to long-range estimates from Social Security's actuaries, the plan will pay for itself on a cash flow basis by 2031. When financing costs are included, the plan pays for itself by 2047 and generates $122 trillion of unified budget surpluses over the entire 75-year period. These surpluses allow a 2.5 percentage point reduction in the payroll tax rate in 2050, and a further 1 percentage point reduction in 2060.

Over the first 15 years, the plan is fully financed with Social Security surpluses. For the first time ever, Social Security surpluses will actually be set aside to pay Social Security benefits. Beyond the first 15 years, the plan will be financed with budget surpluses (if available) or with other financing mechanisms. Data from Social Security's actuaries show that even if the program is financed with public debt from day one (which won't happen because we have Social Security surpluses for the first 15 years), the plan still saves Social Security, pays for itself in the long run, generates $122 trillion of unified budget surpluses, and pays off any loans created by the program. Thus, the plan works even if we never have budget surpluses at any point in time over the next 75 years.

Moreover, the plan does not rely on historical rates of return to save Social Security. A sensitivity analysis conducted by Social Security's actuaries shows that the plan would practically eliminate Social Security's long-term deficit even if the rate of return is as low as 4.35 percent. (A 4.35 percent return would reduce the long-term deficit from 2.07 percent to 0.08 percent). Even if the rate of return is zero, we would still be better off than under current law because cash balances would be available to pay future benefits.

ECONOMIC EFFECTS OF THE GUARANTEE PLAN

The Guarantee Plan would primarily affect the economy by increasing national savings. National savings is the sum of government savings and private savings. Thus, national savings increases when the government pays down the public debt and when businesses and households save more money.

Over the next 15 years, the Guarantee Plan uses Social Security surpluses to finance individual accounts, which are invested in private financial markets. This money directly increases private savings and, therefore, increases national savings as well. In essence, the Guarantee Plan has the same beneficial effects as public debt reduction: more money is channeled into the private financial markets where it is invested in productive assets that generate economic growth.[1]

However, using the surpluses to finance individual accounts is a more effective way of increasing national savings than public debt reduction. Surpluses can only be used to reduce the public debt if they are not spent by politicians as they arise. Allocating the surpluses to individual accounts ensures that the money will actually be saved and not spent. In essence, the Guarantee Plan creates the strongest lock box ever by taking the money out of Washington and putting it into individual accounts where it can be invested productively.

Economic effects beyond the first 15 years depend on the budget outlook at that time. To the extent that the Guarantee Plan increases national savings in the first 15 years, it is more likely that future surpluses may materialize. If future surpluses do not materialize, the government may have to borrow to finance the accounts. However, this borrowing would not adversely affect the economy because the proceeds will go directly into the financial markets: government savings will fall by a dollar, but private savings will increase by a dollar. Moreover, the return on the private savings will outweigh the interest owed on the government debt.

ADDRESSING CONCERNS

This section address two of the most common concerns about the Social Security Guarantee Plan.

ACCOUNT BALANCES ARE "CONFISCATED" AT RETIREMENT

Every individual account proposal has some mechanism by which Social Security's costs are reduced. Some plans reduce Social Security's guaranteed benefit and use account balances to supplement the reduced benefit. Other plans offset Social Security's guaranteed benefit by the amount contributed to the accounts grown at some hypothetical rate of return. Still other plans use a combination. The Social Security Guarantee Plan transfers account balances to the Social Security Trust Funds to help finance workers' benefits. This method was chosen for three reasons.

First, it allows us to maintain the defined benefit nature of the program. Social Security is a safety net—it is not, and was never intended to be, a primary source of income during retirement. As a safety net, Social Security should provide a guaranteed benefit. In fact, a series of nationwide surveys found that a small majority of Americans favor allowing workers to have personal retirement accounts. However, when forced to choose between retirement accounts and a guaranteed, exact benefit, 59 percent prefer the exact benefit and only 33 percent opt for individual accounts.[2] Turning Social Security into a defined contribution plan reduces its role as a safety net and creates direct competition with private savings and employer pension plans.

Second, it enables us to shield individuals and their benefits from market risk. Under the Guarantee Plan, all risk is born by the government, not the individual. Other mechanisms of reducing Social Security's costs place workers and their benefits at risk—some people may do better than current law, but others will do worse.

Third, it allows workers to continue receiving one check from the Social Security Administration for the full amount of their benefit. Providing workers with one

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[1] Individual accounts may cause some people to save less in other forms so that national savings does not increase dollar-for-dollar by the amount contributed to the accounts. However, leakages occur with public debt reduction as well. For instance, some of the money that is no longer tied up in Treasury securities may flow to overseas investments or be used to finance consumption. Thus, it cannot be claimed that public debt reduction results in more national savings than financing individual accounts.

[2] Americans Discuss Social Security, Report to Congress, June 1999

check for their full benefit emphasizes our commitment to maintain the program, not dismantle it.

GENERAL REVENUES WILL BE USED TO SUPPORT THE PROGRAM FOR THE FIRST TIME EVER

Every single individual account proposal that restores Social Security's solvency for 75 years relies on general revenues to some extent. Some of the plans create a permanent claim on the General Fund, and this claim increases in the future.

The important question is whether the use of general revenues increases or reduces the overall burden on taxpayers. As explained earlier, the use of general revenues in the Guarantee Plan is offset by savings to the Social Security program. Over time, the savings to Social Security outweigh the use of general revenues, resulting in a lower overall burden on taxpayers. The lower burden is clearly embodied in the fact that the future payroll tax cut is larger than the cost of financing the accounts.

In the long run, the total cost of supporting the Social Security system is lower under the Guarantee plan than it is under most of the individual account proposals that restore 75-year solvency.

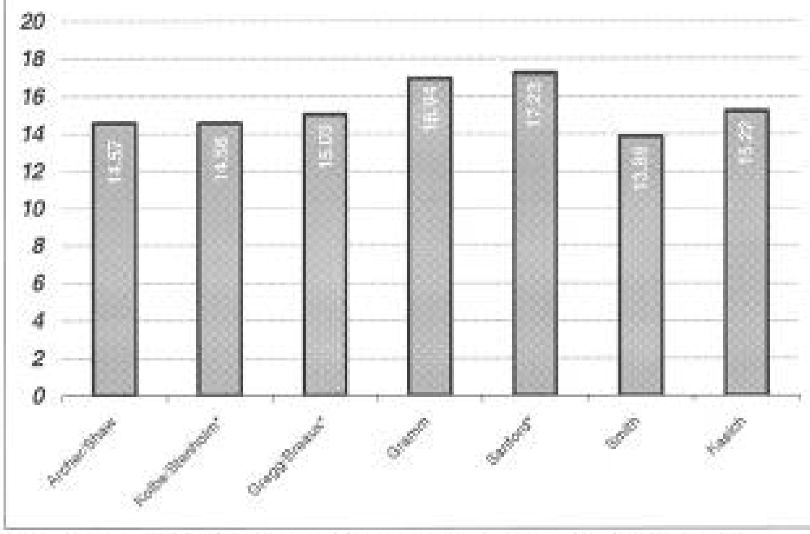
Thus, the Guarantee Plan does use general revenues, but it also reduces the taxpayer burden significantly relative to current law. Moreover, every dollar of general revenues goes directly to the private financial markets where it is available for business investment. This is the most productive use of general revenues.

The plan simply pumps more money into the system without fixing the problem.

We believe that Social Security is facing a financing problem, and fixing that problem should not equate to cutting benefits. We fix the financing problem by using general revenues to pre-fund future benefits. This pre-funding substantially reduces Social Security's annual costs so that the overall cost of running the program (including the cost of financing the accounts) is lower than current law. For example, under current law, the average 75-year cost of supporting Social Security is 16.64 percent of taxable payroll. Under the Guarantee Plan, the average 75-year cost of supporting Social Security is only 14.57 percent. (The cost of paying benefits is 12.57 percent and the cost of financing the accounts is 2 percent.)

In fact, when all costs of supporting Social Security are taken into account (i.e., paying benefits, funding individual accounts, general revenue transfers to the Trust Funds, etc.) the Guarantee Plan is less expensive than almost all of the individual account proposals that have been estimated as restoring 75-year solvency (see Figure 2 on the following page). Thus, the total taxpayer burden of supporting Social Security is smaller under the Guarantee Plan than under most other proposals to save Social Security. Figures showing otherwise exclude the general revenue transfers to the Trust Fund.

Figure 2. Average Cost[1] of Supporting Social Security
[as a percent of taxable payroll]



Source: Calculations based on data from the Social Security Administration, Office of the Chief Actuary

[1]Includes the cost of paying Social Security benefits, funding individual accounts, and general revenue transfers to the Trust Funds.
*Because data are not available, some costs associated with these plans are not included, such as government subsidies to low-income workers and the cost of financing KidSave accounts.

Chairman SMITH. Mr. Shaw.

STATEMENT OF HON. E. CLAY SHAW, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. SHAW. Thank you, Mr. Chairman, members of the committee. I will be very, very brief. I think Chairman Archer adequately described where we are. Our joint full statement is a part of the record of this hearing.

There are many good plans out there. Mr. Chairman, you have one. You will be hearing others coming in for the balance of the day. All of these are improvements over existing law. We have got to do something, and I think that has to be underscored.

Mr. Archer and I decided at the early moment that we were not going to touch the existing Social Security System, and I think that is very, very important. The law that eventually goes on the books, if it is anywhere near the Archer-Shaw bill, will leave Social Security totally alone. We do not touch it, and I think that is very important to remember. It sets up a refundable tax credit that will be scored wonderfully in regards to all taxpayers. It will set this fund up to rescue Social Security.

When you look at the funding over 75 years, you find only one plan is less expensive than the Archer-Shaw bill, and that is the Smith bill, and it is only by a very small amount. Politically, there is no way that this Congress on either side of the aisle is going to raise FICA taxes. So that is simply not going to happen.

I think also you will find a great reluctance by either political party to step out in front on interfering with the benefits.

It is a must that we do something. What you have before you right now with the Archer-Shaw plan is a centrist approach. It is certainly not the most liberal, and it is not the most conservative. We have been abused from both sides of the political spectrum, and I think that once we have an opportunity to go over this with both of our conferences on the Republican and the Democrat side, I think our plan will provide the basic roots of the plan that the Congress will eventually adopt.

I hope that this does happen. It is going to be more difficult to do it in 2 years than it is in this Congress. It is going to be more expensive the longer we wait. The prospect of doing nothing is absolutely frightening, and it would be a disgraceful mark in history if this Congress fails to take care of the next generation and allows this thing to go the way it is going.

It is important to remember that when Social Security was first put together, there were 42 workers for each retiree. Now there are three. Soon there will be two. This is a huge burden that the next generation cannot handle. It is important that we act, and act now. We have lead time. And it is important that we enact this legislation, and I think that the bill that is before you is certainly the most politically doable, and I would hope that we move ahead with it.

Thank you, Mr. Chairman.

Chairman SMITH. Gentlemen, thank you. And my compliments, because I think the Chairman of the Ways and Means Committee and the Chairman of the subcommittee overseeing Social Security introducing a bill is part of the reason that we have generated more interest in this problem, part of the reason that there are more individuals offering their proposals. So you have moved the debate much further ahead than it would otherwise have been.

Do I understand the proposal to just use surpluses coming into the unified budget, or does it mandate that some of this money come out of the general fund regardless of surpluses?

Mr. ARCHER. Depends what your projections are, Mr. Chairman. We have not seen a run-out of the latest projections that OMB has made relative to the surplus, and we don't know and will not know until the end of this week or at least Thursday what CBO will do in that regard, and we will have to overlay that new projection on the plan.

Chairman SMITH. But would the legislation itself provide for this kind of 2 percent of taxable payroll funded regardless of surpluses?

Mr. ARCHER. Well, Mr. Chairman and members of the committee, because you deal with the very arcane aspects of how we budget, I will take a moment to get into that, if I may. It is not understood too much by the average citizen outside the Beltway.

The money that goes into Social Security is immediately invested in Treasury bonds. It cannot be spent for anything else. Because we have, I think inappropriately over the years, assumed that that can be double-counted and create another surplus, we are dealing today with those kind of semantics and that sort of an approach.

I think it is inappropriate, personally, but the entire budgeting concept double-counts the Social Security surplus.

If you have already invested it in Treasury bonds, it cannot be used for anything else. And you say, oh, but we still have it again, and we can spend it. That is basically not true.

So all of the monies that become a part of any one of the Social Security plans that you are holding your hearing on involve the use of general Treasury money. They have to. And I just think that needs to be made clear, and ours does, too.

Most all of the plans, and perhaps all of them, have some sort of personal retirement accounts as a part of their proposal. Those personal retirement accounts are funded out of general Treasury money. If they are funded out of reduction in the payroll tax, and more money has to be put out of the general Treasury into the Social Security fund in order to make up that difference, you create bankruptcy at an earlier date.

So I think we need to cut through an awful lot of this in a way that members of this committee can do, and understand, yes, every plan uses general Treasury money, and ours is no different.

Chairman Smith. I was just wondering, Mr. Chairman, if it is mandated in the proposal or whether it is somewhat dependent on whether or not there is a surplus. But you don't predicate it in your legislation that you are working on the draft——

Mr. ARCHER. No, and I assume that every one of the proposals that has been put before you does not mandate a surplus because we cannot predict in the future what our economic conditions are going to be. And yet if every one of them is going to solve the Social Security problem, which I think we must do, no one can predict for sure whether there will be enough surplus to take care of it or not.

Chairman SMITH. Have you calculated if there is any income level or any age level where that 2 percent investment would ever totally replace the fixed benefit portion of Social Security?

Mr. ARCHER. Mr. Chairman, based on the Social Security actuaries' projections, and they picked the rate of return, we did not, they said that under our plan the rate of return would be 5.3 percent in real terms. If that were to go up in reality, then it is possible some of the accounts could be in excess of the Social Security benefit. But if it does not over the 75-year period exceed the 5.3 percent, then none of the accounts would be in excess of the Social Security benefit.

Chairman SMITH. We had some medical futurists guess that within 40 years, it is reasonable to expect life expectancy between 100 and 120. How would that affect your plan? A great deal, probably?

Mr. ARCHER. No, all—I think the only standard that we can use, Mr. Chairman, is Social Security actuaries. And we can project or have personal predictions as to what we think might happen. But when you judge these plans, they have to all stand side by side based on the evaluation of the Social Security actuaries.

Chairman SMITH. Congressman Collins.

Mr. ARCHER. And you are young enough to both enjoy that life expectancy.

Mr. COLLINS. Might live to be 100, but the question is will you know that you are at 100? I think the mind is the first thing to go.

I just want to say I commend the two gentlemen. This is the second time I think in 3 weeks that Wally Herger and I have had the opportunity to sit up here and look down at them. They both sit above the dais from us on Ways and Means. It is a privilege to work with both and serve with Chairman Shaw on the Social Security subcommittee.

I have heard a great deal about this plan, so I have no more questions. We have discussed it in detail personally. But I do want to say that back in December when we were at the White House for the White House Conference on Social Security, it was emphasized then by the Commissioner of Social Security that the administration needs to move forward not just with a plan of how to reform or save the retirement system or retirement security system, but also to move forward with a plan that would establish trust between the administration and the Congress.

Because as Chairman Archer has stated, until we have trust, until we have a situation where we know that we can talk about the situation seriously and with an intent to move forward with reform, we will never get anywhere with this. And so therefore I appreciate these two gentlemen, I appreciate the work that they have done. They have put theirs on the table. They trust. They trust the American people, and they trust the Members of Congress, and I know they trust the administration or they would not reveal their wares. I just wish the administration had the same initiative and the same trust for us as we have for him. Thank you.

Chairman SMITH. Congressman Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. I would just like to reflect for a moment on what I think you have accomplished with this plan, which is a very interesting approach. It seems that this is a strategy designed to save Social Security in essentially its current form by eliminating the funding liability problem, but without making profound changes in the nature of the program. And I say that because it seems to me that there is really quite little flexibility in investment options for these personal accounts. There is little or no upside, as I can see it, in terms of the return on that investment for—certainly for most workers that are currently in the work force. And you don't have a complete ownership in the accounts because you force an annuitization whereby the moment after retirement, the value of one's entire savings is turned over to the government.

Did you consider an alternative approach which would give greater flexibility to workers, the freedom to make various investment decisions, and ask people to live with the consequences of those decisions, either greater returns or lesser as the case may be?

Mr. ARCHER. Well, you have, Congressman Toomey, and you have asked, I think, a very good question. You have to weigh risk against gain. Clearly, if you happen to be lucky and you take a bigger risk, you are going to have a bigger gain, but you also have a greater risk of loss, and that has always got to be considered. I don't believe we can leave the workers with an account that is funded by the taxpayers, which all of these programs provide in one way or other, with the free opportunity to invest in Uncle Joe's automobile repair shop or whatever else. And if you are referring to that, no, I don't think we can ever reach that point in any one of these plans.

Now, I don't know what the limitations are in the Chairman's plan, and I will say this, the Chairman comes forward and says, look, we are going to abolish Social Security ultimately, and we are going to rely totally on personal retirement accounts, and his plan stands apart from the rest of the plans in that regard. I personally do not think that is politically doable.

As far as whether you have personal ownership, if you do not require conversion to an annuity at the time of retirement, you will have those people who live beyond actual life expectancy having exhausted their retirement account, and they will become a ward of government potentially. So it seems to me that any plan is going to have to have a requirement that there be an annuitization at the time of retirement to eliminate the winners and the losers.

I don't know how else you can validly look at the future. Once you annuitize, you have nothing left to leave to your heirs in anybody's plans. If you annuitize an IRA today, you have nothing left. You have turned over your property ownership to a third party that has agreed to pay you a certain amount of money for the rest of your life per month, and that is all this we do in our plan.

Mr. TOOMEY. One of the alternatives, for instance, that is implemented in Chile is that the amount that is required to be annuitized is such that you provide a relatively minimal benefit and give flexibility with any savings above and beyond that. That would be an alternative.

Mr. ARCHER. But we are, number one, not Chile. And even José Piñera, whom I have gotten to know very well, does not say that what he has designed for Chile is appropriate for the United States.

I think we have reached the area importantly that will accomplish the end result. Let workers, if they die prior to retirement, leave that money to their heirs if they want to keep it through retirement. They don't have to retire. They can then leave it to their heirs at the time of their death if they do not elect to annuitize and to retire and on to get the coverage of the safety net of the Social Security System.

So I believe that we have given property rights to people. That money continues to be theirs. It continues to stay in their account. The title is theirs, not the Federal Government's. But they are required, if they are going to retire, to annuitize, and that is not very different than many other systems.

Of course, I don't know what Chairman Smith does relative to the long range once Social Security is no longer there, but, of course, Chile guarantees a minimum benefit, which is the equivalent of guaranteeing a Social Security benefit for all time to workers so that if their account falls below an amount that is enough to be able to pay that minimum benefit, the government still has to reach in. It has that continuous obligation for all time. It is not funded, but it is there. And there are variations to all of these systems.

Chairman SMITH. The gentleman's time has expired. I would just like to say——

Mr. SHAW. Mr. Chairman, could I comment briefly on that answer?

Chairman SMITH. Yes. Let me just say very briefly that my proposal never goes above 8.4 percent that would ever go into the private savings accounts to make sure that there is adequate money there for the disability, and we do have a safety net.

Mr. Shaw.

Mr. SHAW. With regard to the very nature of Social Security and the very nature of it, it can be described as the greatest antipoverty program ever put in place here in this country. Lower-wage people may not have the sophistication to do investments, and those are the ones we have to be most concerned about. We have to be sure that the investments are made in a sensible way—that they are widespread, and that they are done by capable people.

There are elements of ownership included in our plan. As the Chairman said, you have property rights in your individual retirement account. If you die before retirement, you can will it away if it is not necessary to take care of survivor benefits. So there are some very strong ownership rights. By case law right now, none of us have a vested interest that we can enforce in Social Security if Congress decides to change the system. This would be an absolute property right, and we have drawn the bill up in such a way so that future Congresses, although they can change the law, but they cannot take away what is in your individual retirement account.

Also it is important to understand that you pick your time of retirement. If you decide you do not want to retire, and you want to leave the individual retirement account to your heirs, you can do it, and it passes along estate-tax-free—no estate tax. Also we do away with the earnings limit, which has not been mentioned here, which is a position that is immensely popular among our seniors. Right now it makes absolutely no sense for us to penalize the guy who has to bag groceries down at the grocery store in order to supplement his income and not penalize the guy who has $100,000 a year coming in in interest and dividends.

Chairman SMITH. Mr. Ryan.

Mr. RYAN. Thank you very much for coming. I wanted to ask you a few budgetary questions from the Budget Committee's perspective.

When you first gave us your original briefing 2 months ago, it was my understanding that you were relying mostly on the off-budget surplus to fund the beginning part of the plan, then the on-budget surplus in the outyears. Right now our projections show us that we have an off-budget Social Security surplus of $1.8 trillion, and on-budget is $778 billion. Those numbers are going to be changed to our benefit in the next few days, and we eagerly await those numbers.

But now looking at the summary, it looks like that you are relying solely on on-budget surpluses to fund the annual tax credit. Is that correct? Is that a change in the plan from its inception?

Mr. ARCHER. The answer to that is no, Mr. Ryan. There is not a change.

Mr. RYAN. So you are relying on——

Mr. ARCHER. We are living within—when we budget, as you know, we budget only out 10 years in the Congress.

Mr. RYAN. Right.

Mr. ARCHER. And in that 10-year period we are living totally within the walled-off lockbox Social Security surpluses which are put there for the purpose of saving Social Security.

Mr. RYAN. So you are relying exclusively on the $1.8 trillion off-budget surplus; not going into the on-budget surpluses of $778 billion?

Mr. ARCHER. That is correct. And let me also add, one of the tremendous advantages of our plan is that it establishes with certification from SSA the ability to save Social Security for all time, improving in the outyears rather than hitting a cliff, and that is something that we should always be concerned about on the basis of $1.3 trillion over the next 10 years. Now, that includes——

Mr. RYAN. Freeing up 500?

Mr. ARCHER. That includes the interest. Actual outlays are $900 billion to save Social Security, but because you are no longer putting all of that money to pay down the debt, you have to recapture the interest charges, and that gets you up to $1.3 trillion, that is included in that surplus of $1.8 trillion. So we have a half trillion dollars available for other purposes after having saved Social Security.

Now, with the new projections, and we don't know what CBO is going to do, but under OMB's projections we will have roughly an additional $150 billion over that 10-year period.

Mr. RYAN. Now, as you know, the mix of surpluses between on-budget and off-budget surpluses, the proportions change fairly drastically over the next 10 years. Right now it is entirely—before we find out in the next few days we are going to have an on-budget surplus, but right now the surplus is almost entirely off-budget. Social Security. And that begins to go down very rapidly over the next 10 years, and the on-budget surplus starts from basically nothing now and then gets very large and basically is the entire surplus at the end of our 10-year window.

Does your plan at any time on its year-to-year basis go into the on-budget surplus for its $1.3 trillion calculation? The reason I am asking this is because if we are reserving our on-budget surpluses, income tax overpayments, for the tax bill that you will be marking up in committee, will your plan dip into your ability to provide that on-budget surplus tax cut? Are we running into each other on this thing?

The tax bill that the Ways and Means Committee has to produce will be solely from the on-budget surplus and hopefully all of the on-budget surplus. But this plan relies on a $1.3 trillion stream which is in the outyears of our 10-year window. I assume that the annual revenue that you require for your plan is fairly substantial. Does that begin to eat into the on-budget surplus?

Mr. ARCHER. Well, first—that is an excellent question. Under the projections prior to the update which we expect this week, we do go slightly for a few years into the on-budget surplus. But you have got to also remember that we are not dealing in a vacuum. We are not using all of what has been locked up in the off-budget surpluses, and that extra money is going to be available on an amortized basis to go out into those years that begin 15 or 20 years out.

And the interest on that money is also available, coupled with the fact that, as I mentioned over the 75-year basis, and I believe that our program does a better job on this than anybody else's, we generate a unified budget surplus of $122 trillion. And I know the gentleman from Wisconsin looks at things long term, because I have talked to you too many times. And there is no doubt that even if we went into the on-budget surplus temporarily, in a relatively small amount in a transition number of years, that even if we had to borrow the monoamortizeable bonds, we would come out way ahead by virtue of the $122 trillion unified budget surplus that comes under our plan. And to me, that is what we have got to do more of, is look at the long term and not simply the short term.

Mr. RYAN. So you don't see our goals as mutually exclusive of fashioning a tax bill out of the Ways and Means Committee that relies on the on-budget surplus and passing your plan?

Mr. ARCHER. I do not. But again I think we have to look at the new projections and see what they show for those intervening years at the same time. And then we have got to throw in the interest that will be on the amount of the off-budget surplus that we have not used that literally can be attributed to that period of time which otherwise would not be there.

Mr. RYAN. I think Gene Sperling said today that it was going to be $107 billion over 10 years interest savings we will have accomplished.

Mr. SHAW. It is important to realize that we don't go into on-budget financing until after 2015. Our plan is completely funded from the Social Security surplus until that time. Chairman Archer spoke about going into it for a relatively short time. This generates $43 trillion of Social Security surpluses after 2044, which allow the payroll taxes to actually be reduced from 12.4 percent to 8.9. That is huge.

It is important to realize here that we are legislating for the next generation. We are going to have a completely funded pension system for American workers. But you have got to get over the transition.

Mr. RYAN. That is your chart on page 4, right?

Chairman SMITH. The gentleman's time has expired.

Mr. ARCHER. Mr. Chairman, would you indulge me just to jump in a little bit and tie together what Congressman Ryan and what Congressman Toomey were saying. In Chile, there had to be added debt. They had to take on added debt in order to make their program work. And it was amortized over a period of years for them to be able to come out with their final result.

I hope we will not have to do that, but if we did it in a program that was the right kind of program where we are putting money to work and creating wealth and more personal savings for a temporary period of time in order to be able to get to the long-term tremendous benefits, that is not bad fiscal policy.

Mr. RYAN. Thank you very much, gentlemen.

Chairman SMITH. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman. I want to thank both of the gentlemen, our two Chairmen, Chairman Archer and Chairman

Shaw, for the courage you have taken. I was present in several of our Ways and Means meetings when we were discussing whether or not you would move forward, whether or not it was wise to move forward or not, and I know at that time there was a lot of discussion about the possible repercussions, that maybe this was not the time to come out with a plan. And I want to thank you for having the courage to move forward as you have with a plan that I think is very beneficial, and so I thank the two Chairmen, and I know we have Chairman Kasich coming up. I will end with that. But thank you very much for what you have offered.

Chairman SMITH. A final comment?

Mr. ARCHER. Yes, Mr. Chairman, very briefly, and we could probably go on for several hours with the comparison of plans. To legislate a CPI fix, which is part of many of these plans, shows a benefit to the Social Security outflow, a reduction in the Social Security benefit outflow, but it also is a hidden tax on middle-income Americans when applied to the income tax. It is a sword that has two edges. It helps on Social Security; it hurts middle-income people by raising the amount of their income taxes which are now indexed for inflation. And I don't think we can be oblivious to that.

Finally, I would say, Mr. Chairman, we have an analysis here of the various plans that we know about today, of which there are eight, as to their total cost in order to create a saving of the Social Security system. And I would like to insert that in the record, if I might.

And let me just refer to the year 2074, which is the end of the 75-year period, the total cost of the Archer-Shaw 12.11 percent of payroll. The total cost of the Sanford plan is 18.38 percent of payroll. And the total cost of the Chairman's plan, which is one of the least costly, is 13.23 percent of payroll.

So in that final year, and those projections will work out in the following years, our plan costs 1 percent of payroll less than the next least costly plan. And actually, that is John Kasich's plan, which is 13.08 percent of payroll. So, if I may, I would like to insert this data into the record.

Chairman SMITH. Mr. Shaw.

Mr. SHAW. Mr. Ryan was making the comment regarding his concern about whether the tax dollars or general revenue on-budget comes in to have to pay these benefits. It is important that all of us not lose sight of the fact that in the year 2014, tax dollars are going to have to start cashing in these Treasury bills. That is when the Social Security surplus dries up. We don't have until 2032 or 2055. Building up more Treasury bills within the Social Security Trust Fund is not going to in any way delay the Congress' having to appropriate revenue in order to have to take care of the benefits. 2014 is our drop-dead date. That is the date we have to be very concerned about.

Chairman SMITH. Absolutely. Gentlemen, thank you very much again.

Mr. Kasich, who was written up today in the Wall Street Journal as being a brave soul in coming ahead with legislation to save Social Security.

[The information referred to follows:]

[From the Wall Street Journal, June 28, 1999]

HOW TO SAVE SOCIAL SECURITY
BY JOHN R. KASICH

Most Americans know that Social Security is headed toward bankruptcy. Nothing makes the point better than the poll taken a couple of years ago in which young people said they had a better chance of spotting a UFO than receiving Social Security benefits.

But many may not know why the system is threatened. In order to develop a solution-one that meets my goal of saving Social Security for today's retirees and those near retirement, the baby boomers and their children-we need to understand the serious difficulties facing Social Security.

Believe it or not, in 1945 there were about 42 workers for each person receiving Social Security benefits. By 1960, that ratio had shrunk to about 5 to 1. Today, it's 3.4 to one and by 2030, there will be just 2.1 workers for each beneficiary.

At the same time, Americans are living longer. That's good news. But it means retirees will receive benefits for a longer period. Americans are also having fewer children, which means relatively fewer workers paying Social Security payroll taxes. It is those taxes that finance current benefits.

Aside from these demographic trends, first-time Social Security benefits are growing far faster than inflation. These benefits now rise with overall wage growth, and wages are rising faster than prices. The result: over the next 75 years, benefits will increase more than 20 times, while prices will go up at half that rate. A retiree in 2060, for example, has been promised annual benefits starting at over $140,000.

The result is a system that would require people in the future to work longer hours and pay more in taxes to support retirees. By 2034, payroll taxes would need to be increased by 50% to pay promised benefits or benefits would need to be slashed. Between now and 2070, benefits will exceed payroll taxes by a cumulative $120 trillion.

Is it any wonder young people don't expect to receive their Social Security?

We must do better, and we can. Every generation of Americans has left a legacy of prosperity for its children. We cannot let our legacy be a Social Security system drowning in a sea of red ink.

My plan does not affect current retirees and those nearing retirement-benefits for those now 55 or older would be untouched. Neither would it increase the retirement age above current law, increase payroll taxes or reduce annual cost-of-living adjustments (COLAs), now or in the future.

We save Social Security by making two fundamental changes to the system for those now under 55. First, this plan changes the way first-time benefits will be calculated. These benefits now rise with overall wage growth. Under my plan, growth in initial benefits would be linked to the consumer price index. Initial benefits would still rise over time, only at a slower rate. Instead of rising 20 times over the next 75 years, they will increase by a factor of 10.

Switching from wage indexing to price indexing will eliminate the unfunded liability of the Social Security system and allow us to avoid increasing the payroll tax for young workers. At the same time, future workers could count on receiving their benefits.

Second, workers currently contribute 6.2% of their wages to Social Security. My proposal allows workers under 55 the option of establishing their own personal savings accounts. Contributions into these accounts would range from 3.5% of wages for low income workers to 1% for those at high income levels. Workers who choose to contribute to these accounts would have a variety of investment options and could withdraw proceeds upon retirement. But as they will be paying less into Social Security, their Social Security benefit will be slightly reduced. The basic Social Security benefit will be reduced by 25 cents on the dollar for each dollar they receive from their personal savings account.

Nonetheless, the private investment account option should offer most recipients the opportunity for greater returns than Social Security alone could generate.

Yes, we are asking some in the baby boom generation to insure the solvency of Social Security by making a sacrifice in terms of accepting a slightly lower initial benefit. An average 45-year-old male, for example, would receive about 1.7% less under my plan, but look what happens in return. First, he is assured of receiving benefits because the solvency of Social Security is assured. More important, his children will receive far more in benefits. Under my plan a 25-year-old male who takes advantage of the personal savings account option should receive 19% more in benefits than promised under the existing system, based on historical averages for conservative investments.

Today's retirees and those nearing retirement will receive their benefits just as they expected. Younger workers can not only count on receiving benefits, they will not have to worry about the prospect of working longer hours and paying increased payroll taxes that would otherwise be needed to keep the current system afloat. If they take advantage of the personal savings account option, they'll have more control over their own retirement resources and the opportunity for greater overall benefits than under our current Social Security system-even if it could pay all their promised benefits.

Finally, and most important, my plan is honest and realistic. The problems facing Social Security have built up for so long and become so mammoth that everyone must realize they cannot just be wished away. This plan makes clear the costs and benefits, and it avoids false promises.

If we are truly concerned about saving Social Security, there is no better plan than this one and no better time to start than today. If we face the challenge now, we can provide for our retirement security without sacrificing our children's and grandchildren's standard of living.

STATEMENT OF THE HON. JOHN KASICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. KASICH. I want to thank Mr. Stenholm for letting me slide in here. I want to just basically lay out precisely what we are doing. As I know you have had a number of hearings and the full committee is going to start having hearings very soon, there are really fundamentally, as you know, three things I hope you know, three things that are driving Social Security to bankruptcy. One, of course, is demographics which we all know about; the second issue is that people obviously are living much longer, which is great news, which also contributes to the fiscal situation with Social Security; but the third reason is the way in which we create initial benefits for Social Security, which is based on a wages and prices program that was designed to replace wages of people when most Americans were fundamentally below poverty. In fact, many years ago, the Social Security program represented a percentage of poverty and now we are providing money well above the poverty rate.

That is all good. In fact, what has happened is senior citizens have been able to systematically move out of poverty. But here is what I get down to in this program:

First of all, this is not sustainable. And it is not sustainable because of this large factor of growth in these initial benefits, this initial starting point. If what we were to do was to—I don't finish, you know, the complicated factor whereby benefits are initially established, but in the year you turn 60, they take the average wage of every American and they divide it by the average wage of your other 34 years in the workplace, because they come up with this initial benefit based on 35 years' worth of work.

They take the average wage when you are 60, divide it by the average wage of your other 34 years, multiply times your income, which gives you a yearly number. Then they break it down into 12 months and then they replace the first amount of income with 90 percent of your income at the low levels. It is a very complicated formula. And it is a factor of wages and prices that establish your initial benefit.

I think that first of all, it is essential that we make Social Security balance, flat out; that we need to make sure that the program is not just based on economic factors that are removed from Social Security. I think we need to make Social Security balance in and of itself and then create the individual retirement accounts that allow us to have more growth than what the benefits provide.

Now, Mr. Herger, if we were to establish the initial benefit in this complicated formula on the basis of prices, which is exactly how our seniors today have their benefits determined, and we exclude wages, what we will do is we will balance the Social Security program. Period. Flat out. It will balance. In a number of years, but it will balance.

And then what we do in this program is to then permit you to have a part of your payroll tax for investing in the private economy. Now if you are a 45-year-old man under my program, over your lifetime you will receive 1.7 percent less than what you were promised by the government, but your 25-year-old son would be able to earn 20 percent more than what the current system promises.

You would have an individual retirement account established under your name. It would be an individual retirement account that you could have as part of your estate. The government would not recapture it. The government doesn't own it, you own it. And it is amazing when you stop and think that for a 45-year-old man to give up a total of 1.7 percent in benefits over a lifetime in exchange for having his son or his daughter in a position of where they can earn at least 20 more than what Social Security promises, and we know that Social Security promises are empty promises, you will have balanced the system forever. It will not be based on just the theory of how fast the economy grows; it will be based on the fact that we brought Social Security into balance and add on top of it an individual retirement account that we control.

It does nothing beyond that. It does not affect the cost of living increases, it doesn't affect anymore the CPI. It essentially says we balance Social Security by slowing that starting point and in exchange giving Americans the freedom and the security to be able to have individual retirement accounts out of their current payroll taxes that would provide for a very secure system.

I maintain that in this whole debate on Social Security, the issue of wages and prices have never emerged before, I have never heard it discussed before. The beauty of this is it doesn't mean we have to go in and change anybody's COLAs. It doesn't mean we have to monkey around with the CPI.

But I want to commend my friends, Mr. Kolbe and Mr. Stenholm, because I think frankly they have been the leaders on this. No question. And every time I look at how you can get there, you try to build a better mousetrap. I believe that if we can slow the starting point, politically it is the best way to go.

Secondly, economically, it is the best way to go, and thirdly, not only will it balance the system, but it will guarantee retirement security for every American based on the notion that the long-term rate of return is at 5.3 percent with 60/40 investment in stocks and bonds. I mean, think about this.

The other thing I want to make is that nobody knows what their starting point is with Social Security anyway. Nobody sits around and calculates the 35 years and the replacement wage. Nobody knows that. So if we just tell the baby boomers that you have got to take a little bit less—and the other final point is, if you are under the age of 45, you don't lose anything because the power of compound interest makes up for those benefits that you have foregone in terms of your starting point.

So virtually everybody in America wins and we have balanced the system. Do you understand what I am suggesting? If we do not slow the growth in the starting point of benefits, you cannot fix this problem. You cannot guarantee a fix of this problem. That is why it is necessary to do both things: To slow the growth and starting point of the benefits while at the same time giving people the economic freedom to invest in our economy.

Mr. Chairman, thank you for giving me the opportunity to be here and I hope you will take a very good look at this approach to this problem that needs to be resolved.

[The information referred to follows:]

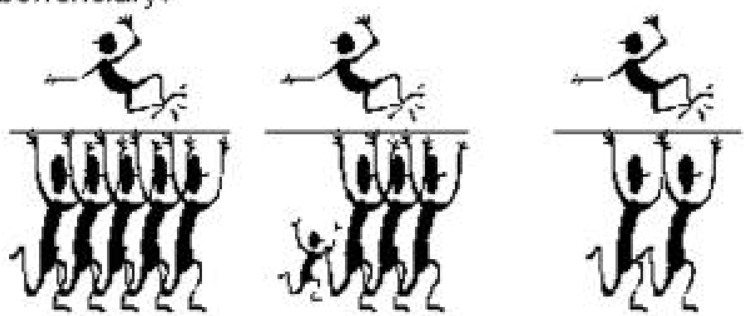
Saving Social Security...

...for three generations of Americans

> "A law that will give some measure of protection to the average citizen and to his family against the loss of job and against poverty ridden old age..."
>
> --President Franklin D. Roosevelt

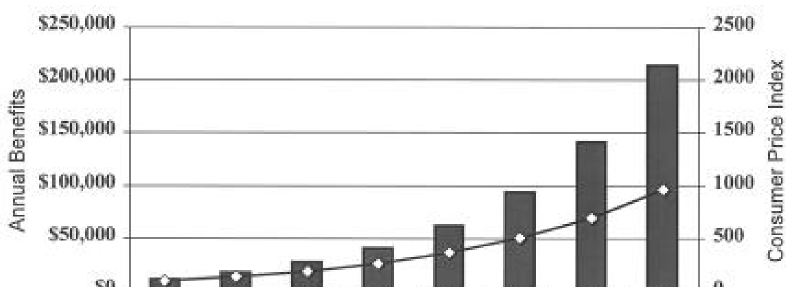
Why is **Social Security** going **bankrupt**?

Americans are living longer and having fewer children. Fewer workers support each beneficiary.



1960 (5.1 to 1) Today (3.4 to 1) 2030 (2.1 to 1)

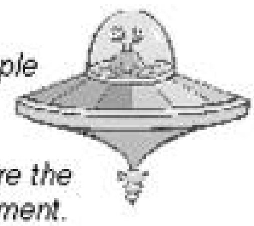
Initial benefits are growing faster than inflation.



	1999	2010	2020	2030	2040	2050	2060	2070
Benefits	$11,448	$18,192	$27,408	$41,232	$62,232	$93,912	$141,708	$213,840
CPI	100	138	190	263	364	504	698	965

The Q and A's

Q: Are young people going to see a Social Security check when they retire?

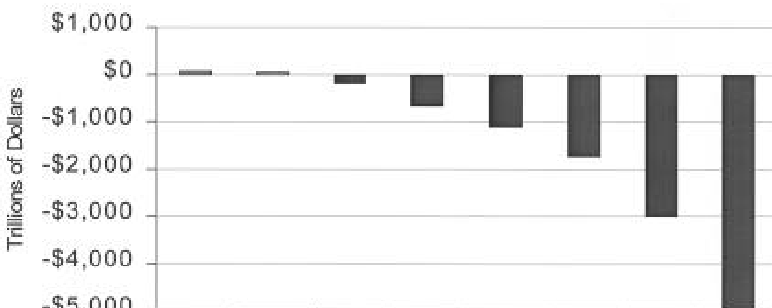


A: *In a recent poll, more young people believed in UFOs than believe in the future of Social Security. To save the system, we must restore the freedom to secure one's own retirement.*

Q: Won't strong economic growth save Social Security from bankruptcy?

A: *No. Under the current law, the faster the economy grows, the faster the benefits grow. The gap between taxes and benefits is never closed.*

In the new millennium, Social Security will face a tidal wave of red ink! Benefits will exceed payroll taxes by $120 trillion!



	2000	2010	2020	2030	2040	2050	2060	2070
Current Law	$70	$49	-$200	-$666	-$1,116	-$1,732	-$3,002	-$4,993

The **promise** of Social Security is about to be ***broken***.

- ✗ ***By 2014, promised benefits will outstrip taxes collected.***
- ✗ ***By 2034, the Trust Fund will be depleted, leaving only enough revenue to pay 70% of benefits.***
- ✗ ***Unless payroll taxes are increased by 50%, the promise of Social Security will be broken.***

We **can** do better and **we must!**

"Every generation of Americans has left a legacy of prosperity for its children. The Baby Boomers must not let Social Security's tidal wave of red ink be our legacy to the next generation."

--Chairman John R. Kasich

The Kasich $ocial $ecurity Plan

PART A: Price Indexing

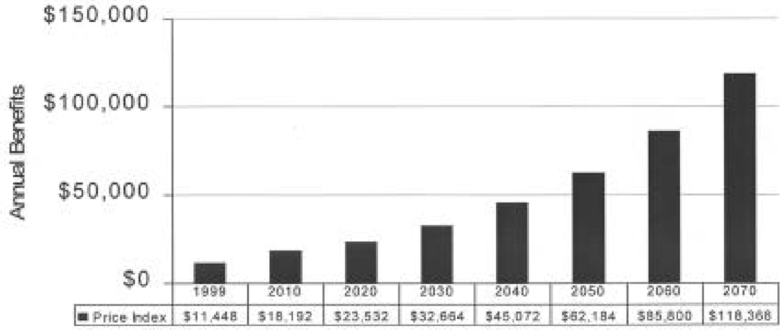
Price Indexing would tie initial benefits to inflation.

Initial benefits would increase at a slower rate, but **still grow 10 times over the next 70 years!**

PART B: Personal Savings Accounts

Workers can invest a portion of their payroll taxes in their own Personal Savings Account.

The exact amount they can invest is based on their annual wages.



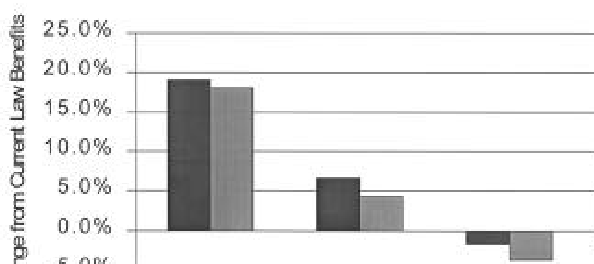
	1999	2010	2020	2030	2040	2050	2060	2070
Price Index	$11,448	$18,192	$23,532	$32,664	$45,072	$62,184	$85,800	$118,368

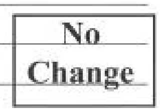
Initial Annual Benefit for Average Wage Worker at Normal Retirement Age

Under this combined approach…

Most people will do as well or better under the Kasich Plan

Combined Benefits of Social Security and Personal Accounts





	Age 25	Age 35	Age 45	Age 55 and over
Male	19.0%	6.6%	-1.7%	0.0%
Female	18.0%	4.3%	-3.7%	0.0%

Are we ready?

Under the Kasich plan, a 45 year-old member of the baby boom generation might give up 1.7 percent of his retirement.

But in exchange, he will allow his kids to earn almost 20 percent more for their retirement.

Chairman SMITH. Chairman Kasich, I think this is our 12th Task Force meeting and I would just like to point out the bill that I wrote in 1995 did exactly what your bill does, but we only changed it from wage inflation to CPI inflation for the second and third bend points. You also change it for the first bend point. Let me ask you, why did you consider or rule out any change in the CPI in developing your solution to Social Security?

Mr. KASICH. Well, because the CPI has already been significantly adjusted. And if you take a look at what the—I can't remember the guy's name, who was the guy that did—the Boskin Report, we have already made significant adjustments in the CPI. Now I am sure you can make the argument that we can squeeze some more out of it, but I just think it is unlikely we are going to pass that. I think—and I don't even know if it is going to be accurate.

In terms of change in CPI, it is very, very difficult. And as you know, Mr. Smith, this committee struggled mightily with the issue of CPI with the Bureau of Labor Statistics, and we were able to move them to a large degree to upgrade the CPI calculation. I just am not convinced that there is a whole lot left to wring out. And frankly, that starts affecting your benefits on almost a yearly basis.

I mean, if you can remove this significant cost driver from the initial stages of the formula, you don't—you never have to go back and look at CPIs or COLAs or anything else. The benefit flows straight out.

Chairman SMITH. Is your plan voluntary?

Mr. KASICH. Yes.

Chairman SMITH. Does your plan have any special provisions for women?

Mr. KASICH. No. But what we do is we maintain the progressivity of the system so if you are at the top end you will get 1 percent of payroll tax into an account, but if you are at the lowest end you will get up to 3.5 percent. So we wanted to make sure that Social Security replacement concept progressivity was maintained in this plan. And the reason why, if you take a look at the benefit life of women in some categories, it appears as though women don't make out as well as men. It has to do with the total period in which the loss of benefits are calculated because women live longer. But we have no special provisions affecting anybody else other than this progressivity factor retained.

Chairman SMITH. Explain how the personal retirement savings accounts are offset for any reduction in fixed benefits.

Mr. KASICH. You would lose 25 cents on every dollar that you earned from your private account. So not only would you begin your Social Security at a lower starting point, but for every dollar you earn in your private account, you lose a quarter, you make out 75 cents. The amazing thing about this approach is that virtually the entire public benefits.

Mr. Archer's plan, you don't get your private account. You don't have the potential to earn more than what Social Security promised. Under my program, you can earn an immense amount more than what Social Security promised at the same time that Social Security comes into balance.

And remember, when you say that a 25-year-old son or daughter can make 20 percent more, that is based on a 60/40 ratio. If you were at 80/20 ratio, stocks to bonds, then your potential to earn far more than even the 20 percent is there.

Chairman SMITH. Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. And thanks for joining us today, Mr. Chairman. A couple of questions. Does your plan contemplate forced annuitization at the point of retirement? That the savings be required to be converted into annuity?

Mr. KASICH. No, they do not.

Mr. TOOMEY. So the person continues to have true ownership?

Mr. KASICH. Absolutely. This actually becomes part of your estate. This is your account.

Mr. TOOMEY. Before and after retirement?

Mr. KASICH. Absolutely.

Mr. TOOMEY. How about investment options? Do you contemplate giving individuals a considerable degree of latitude, or would do you as Archer does and say equity funds——

Mr. KASICH. No, I would do it the same way we do our Federal program. I mean, what we anticipate, that we would have companies that would seek contracts to be able to provide the menu list of choice, because I know there would be a lot of people that would want to do better than 60/40. So we want to give people a lot of flexibility. Maximum flexibility.

Frankly, I would like to be able to give them their money, but my concern is then that people would put all of their money in an IPO. And Social Security is a contract that we have made in this country that is going to be a bedrock of the way our government works. So I think that to give them the maximum flexibility, like we have in thrift savings, is the way to go. And I understand thrift savings will be offering us even more investment opportunities.

Mr. TOOMEY. So there are certain restrictions. You presumably cannot leverage the funds and get involved in very risky investments, but otherwise you would advocate a great deal of latitude.

Mr. KASICH. Without question; yes, absolutely.

Mr. TOOMEY. Did you consider a different approach in the considerations of the personal accounts? It suggests that it ranges 1 percent to 3.5 percent and that is a function of a person's income. Depending on the trade-off, the reduction in fixed benefits, could we not accomplish as much, maybe even more, by allowing more people to have a greater contribution to their personal account?

Mr. KASICH. Well, as you know, Mr. Toomey, this is a matter of filling various holes. I mean, I would love to give 8 percent, but how are you going to handle the transition period? How do you handle the people who are retired today? But what I try under my program is after—you see, what happens is you start running a surplus in Social Security as a result of establishing initial benefits based on prices, and not prices and wages. And you run a huge surplus that can be used to do two things. One is to cut payroll taxes or, two, to allow larger private accounts that will be a decision for our children to make, because I believe that Social Security for our children is going to look dramatically different than it looks today, but we have got to get started in this process, and those surpluses would allow people to have more in a private account.

But you know, what I suspect is that our children would rather have their payroll taxes cut and take their money and put it in Ebay. That is what I suspect because I think the younger generation is distrustful of government and they have concluded that there is not a wizard behind the curtain; there is just a tired old man.

Mr. TOOMEY. And given the average return that the market has consistently returned over the entire history of this Nation and comparing that to that which Social Security promises and cannot deliver, I think there is a lot of truth to that wisdom.

I will yield the balance of my time, but I would like to say that I congratulate the Chairman. I think this is a tremendous contribution to this debate and a huge step forward in terms of freedom, in terms of solving the fiscal problems and making Social Security very different and better for the next generation.

Mr. KASICH. I think that it is the most reasonable approach, would not force us to come to this floor and start adjusting COLAs or whatever, which is what we always do around here. It gets it solved. It balances the system. It creates private accounts that are yours, that go to your estate, that give you the ability to earn far more than the current system. To me, it is a lay-down, it is a "gimme pot." The next President ought to put it in.

Chairman SMITH. Mr. Collins.

Mr. COLLINS. Was that last statement a campaign statement?

Mr. KASICH. It wasn't, Mr. Collins.

Mr. COLLINS. And why not? Let me ask you this, Mr. Chairman; 3.5 percent is the opt-out figure for low-income wage earners; right?

Mr. KASICH. That is the amount that you would be permitted to put in your account; right. Everybody is going to want to be in this. I can't imagine anybody not wanting to be in this.

Mr. COLLINS. What is the range of wages that apply to 3.5?

Mr. KASICH. I don't have those figures in front of me, but they are obviously the lowest-income workers.

Mr. COLLINS. The highest would be 1 percent?

Mr. KASICH. One percent, correct.

Mr. COLLINS. Why is there a variation?

Mr. KASICH. Because the system was created to be progressive. It was created to provide the greatest amount of replacement wages for people at their first dollar of earnings because we wanted to try to rescue people from poverty. And the people at the very top, their 1 percent gives them more money and they also have a lot of other investment opportunities. And the people at the very bottom are putting just a little smaller amount into their fund.

So I think you could take issue with the progressive nature of it, but I just think it is the fairest way to go on a program like Social Security.

Mr. COLLINS. Is there a ceiling on the wages earned for the 1 percent?

Mr. KASICH. Well, it is that $72,000 or wherever those numbers go to ultimately.

Mr. COLLINS. Would there not be a greater incentive to opt-out for the higher income through $72,000 if the percentage was more?

Mr. KASICH. No. When you do the numbers you find out that anybody under the age of 45 wins. You either—you do better than what you would do under the promised program of Social Security at all income levels. I think there are a couple—I think that is accurate in and of itself. Yes, everybody would win, so everybody would want to opt into this program.

What I worry about is that—you see, the surplus on Social Security is so important because what it allows you to do is to start these private retirement accounts, and what I get concerned about is that we enact some kind of a program on Social Security that really does not force Social Security to balance in and of itself and is based on theory. That is my greatest concern.

But in terms of the 1 percent, the 3 percent, I mean, I can't imagine any American that would not want to opt into this program since the numbers turn out so well for everybody.

Mr. COLLINS. What you are getting around to, then, is anybody 45 or under is a winner. They would receive total retirement or benefit from their personal account, none from Social Security?

Mr. KASICH. No, they would get both. You put the two together. They would get their Social Security benefits but they would be established on the basis of prices and not prices and wages. And you take that amount and you combine it with your private retirement account measured at what we are all assuming, the 5.3 percent is what you would get from the 60/40, ratio and that is how we calculate how you would do under the program. And people who are 45 years old could actually not lose their money if they invested 80/20.

Mr. COLLINS. Well, your program doesn't give you the option to entirely opt out of Social Security.

Mr. KASICH. Oh, no; no, it does not.

Mr. COLLINS. Have you looked at that approach?

Mr. KASICH. Well, I don't think that that is a manageable program if you buy into the fundamental basis as to why we established Social Security, Mr. Collins. I think that that is a very interesting discussion and debate that can occur probably a couple generations down the road. But I don't think that is where we ought to be today and it is not where I am today. I see Social Security as something—see, my problem with it is if you give everybody a total opt-out and you make sure that we are going to have some kind of a survivor benefit for people who invest their money in Uncle Joe's pork bellies and lose everything, then we have to create a welfare program for our seniors that lost all of their money, which is why I believe you have to have a program like this.

One other point I would like to make is that there is a notion that if the economy grows fast, that we can grow our way out of the Social Security problem. And it is simply not true. You don't make any headway based on strong economic growth. But I think your question is a legitimate one and our children are going to have that debate, and probably it is going to be pretty fierce if we can take the first few steps.

Mr. COLLINS. Thank you.

Chairman SMITH. Except, John, with your proposal and my proposal, an expanding economy is going to be much more significant as we change it to a CPI inflation rather than wage inflation.

Mr. KASICH. I am saying if the economy is growing strong, this thing is gangbusters. What I am saying, Mr. Smith, is that there are a lot of people who think that the current Social Security problem can be solved if we just have rapid economic growth. But the system is set up that the more rapidly wages grow, the more benefits you pay, so you can't get out of it. And the other problem is, of course, the longer we delay on this, look, everybody in this room who is here obviously, and particularly the young people, have an interest in this program. Providing it for young people is essential to, I think, restoring a little confidence. Every year you delay compound interest is every year that you lose a chance to get ahead. That is why you have got to do this soon.

Chairman SMITH. Mr. Ryan.

Mr. RYAN. Thank you. Thank you very much, John, for coming. And I had the opportunity of visiting with your staff, Steve Robinson, to go over this plan last week. And what I think your plan does is highlight a really important issue that we have been talking about a little bit, which is the wage peg and the price peg. One of the newspapers recently just brought that out as well.

Can you shed some more light on the wage peg versus the price peg, when and how that change is scheduled to occur, and how changing from the wage peg to the price peg is not a cut in benefits—it is actually still increasing benefits? How does it also help us solve the huge liability in the outyears?

Mr. KASICH. Well, the first thing we have to realize is that it is the price peg that our seniors now are geared to when it comes to their cost-of-living increase. So what we would be doing is essentially saying that our benefits would have growth, but the growth would not exceed——

Mr. RYAN. Prices.

Mr. KASICH. It would not exceed prices and it would not exceed that indexing which occurs with our senior citizens today. So you would have a slowing of the starting point, yet you wouldn't be going backwards. I hate to get into this slowing the growth, but I suppose that is how you would argue this. You slow the growth in the establishing of benefits.

But once it is established, of course, then you get the juice on the other side, which is the ability to invest in the economy at a far faster rate than what the rate of return is on a government investment. And I mean, it has got to be astounding to everybody to find out if you are under the age of 45, you win. The only people who have to pay are people like me. I stood on my parents's shoulders to get where I am. I don't want to stand on my kids' shoulders to get out of this. I can give up a little of this. Frankly, most Americans don't think they are going to get any of it anyway. It is a reasonable approach to being able to solve this.

And, Paul, it has got to be wages and prices because in the early years, essentially, we were trying to get people really out of poverty. And the wages and the prices were a way to try to make this system equitable. If we don't change wages and prices, we will grind down. All the plans at some point have to borrow from the general fund. Mine, fortunately, becomes totally self-financing.

The other programs—I don't want to comment on Mr. Kolbe's because his and Mr. Stenholm's both do as well, which is why I take my hat off to them. But the inability to deal with the benefits side means we will not fix this and we will keep robbing from the general fund or driving up huge, huge—not minor, huge borrowing costs.

So what you get with this program, I mean, think about it, a little lower starting point where virtually all Americans benefit. We have more retirement security, we have private accounts that we control, that we can pass on to our families. That allows us to earn more than what the current system provides. And I understand Mr. Archer's plan does not even permit that. You don't have an opportunity to earn more than what the government program provides.

Mr. RYAN. I am glad you brought the Archer plan up. He was just here. I asked him as a Budget Committee member about the score, the cost for our purposes of budgeting. And he is supposed to prepare a tax bill using all on-budget surpluses for that tax bill. I was unsure as to whether his bill eats into that tax bill, that on-budget surplus. As the Chairman of the Budget Committee, I know you are acutely aware of off-budget surpluses going to debt reduction and on-budget going back to the taxpayer who produced it.

What is the score of your bill? What does it do with respect to the off-budget surplus? How much would it take of that? Is it totally self-funding?

Mr. KASICH. The off-budget, all of it goes into creating the accounts; and at some point when this program starts nose-diving into the ground, you have to incur some debt from the on-budget side. But the beauty of this is that it becomes self-enforcing because at some point the payroll taxes collected will be much greater than the benefits that are passed out, and at that point you can reduce payroll taxes or you can create larger private accounts.

Under the other plans that I am aware of, look, I don't know about all of these plans, I haven't studied them all, but I know that programs that do not in some way, shape, or form impact benefits are programs—I mean we all know intuitively that if you do not slow some of this benefit growth, you are not going to make it, and that your borrowing costs are going to be enormous.

And I think if we were trying to ratchet somebody down and clobber somebody, it would be unacceptable. But if I am going to tell you that a 45-year-old guy loses less than 2 percent in exchange for an amazing benefit for everybody else in our society that will probably also drive up the savings rate in America, it is a very, very small price to pay for making this program solvent.

What I fear, Paul, is that we are going to go ahead and pass something and we are not going to get to the nub of the problem.

Mr. RYAN. And just delay the problem. I just wanted to clarify with you, your plan doesn't eat into our on-budget surplus and therefore take away from the tax reduction that we are hoping to achieve in this budget in this Congress?

Mr. KASICH. It would not.

Mr. RYAN. That is an important point. Some plans do. As a gentleman under 45——

Mr. KASICH. You need to know that at some point when the off-budget surplus doesn't provide enough money to finance the private retirement accounts, there will be a borrowing cost on the general revenue side. But at some point it ends because mine is self-enforcing.

Now, remember, we also found out presumably that we have got about a trillion dollars more in surplus. Now, I must tell you that that then means that our borrowing costs for financing the Social Security plan would be reduced, but it also gives us perhaps a great opportunity to fix Medicare. I want to bring to your attention that Medicare is a far more acute problem than Social Security. That is why it is so important we don't fritter away this surplus on more government spending, but use that surplus to be able to address these huge entitlement challenges that we have for the next generation.

Chairman SMITH. The gentleman's time has expired.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Let me say at the outset, some specificity from a candidate for the Republican nomination for the presidency is increasingly uncommon and I commend you for that. And I know the Chairman has thought long and hard about all of these issues. And I apologize for not being here for your opening testimony. I was caught up in another meeting.

Let me also reference the comment made by my young colleague on the other side with respect to the previous speakers, that that is a critical element, that you can only spend the on-budget surplus once—you can spend it twice, but we are only supposed to spend once or we get into the problem that we have been in before.

With respect to the wage—first of all, have you had your program scored by——

Mr. KASICH. That is all worked out.

Mr. BENTSEN. By the trustees and all? With respect to the wage peg, if I understand this correctly, for future or new retirees, you would just eliminate the wage peg so that the initial average benefit would be whatever it is, $740 a month today or something like that, and it would just stay there, flat——

Mr. KASICH. No, the initial establishment would be on that complicated formula that takes your average wage at 60 and divides it by your average wage in the other 34 years, times your income, to give you a yearly total and breakdown into 12-month totals, and then there is a factor applied that includes both wages and prices—that initial factor would be based on prices and not wages. But then beyond that, you would grow, because we don't affect CPI or anything else.

Mr. BENTSEN. Right, you would grow based on the annual COLA.

Mr. KASICH. Correct.

Mr. BENTSEN. But initially——

Mr. KASICH. And you would receive a lesser amount.

Mr. BENTSEN. No adjustment going forward for adjusting the wage base in effect.

Mr. KASICH. Correct.

Mr. BENTSEN. How did the Social Security actuaries score that over the 75-year period in terms of—did they make any projections as to what the net reduction would be?

Mr. KASICH. Yes, they did. I don't have those numbers in front of me, but in about 30 or 40 years, the system balances itself and then starts to run a huge surplus. And then that surplus, of course, can be used either to reduce payroll taxes or to increase the amount in the personal account. Mr. Bentsen, I would argue that your children probably would rather have a lower payroll tax so they could have the freedom to invest as opposed to staying in the——

Mr. BENTSEN. Mine would like to have the freedom to spend, has been my experience so far. But nonetheless, if you could provide my staff with——

Mr. KASICH. Yes, we will get you all the details of this program.

Mr. BENTSEN. That is what I would be interested in.

Mr. KASICH. The inability to be candid on these major issues is not limited to certain classes of people. I have talked to my own

Republican colleagues who, when they find out that you may not be giving everybody a chicken in every pot, probably all the way down to the school board level people are like, oh, that is the "third rail."

I have to tell you I think the public is ready for changes in this, and I think they are ready for some straight talk; and frankly, this is not any different than what we did with trying to balance the budget. As you know, we had to make choices and a lot of times those choices meant that some people would get less. But look at what the result has been, not that that is the reason that the economy has done so well, but if you take a look at the stock market, and if we keep going like this we will be at 20,000. I am not so sure that that is not an accurate projection.

I think the beauty of this plan is that for people under the age of 45, they are a winner in every single way. And it just takes such a small give on the part of a limited number of people in order to make this whole thing work. I don't think it takes any great courage at all to do this. I think it is like falling off of a log. I think it is pretty simple. And I think you are the kind of person that says, I didn't come here to waste my time either, I might as well just get some things done. I think it is the nature of the individual in this. But I think that our Congress needs to realize that I think on this issue, it is time for it to be done.

Mr. BENTSEN. Well, I would just tell the gentleman, generally I would concur with you. And I think that being up front—and I know our next panel has done this as well, and the first panel we had today in getting into specifics. And where the adjustments are made, where the cuts are made, is important because I think what the American people want more than anything else is honesty. They are willing, I think ultimately, to take the tough medicine if they think you are being honest with them. We may have disagreements on how we get there, but we need to deal in specifics, not broad generalities, which as the Chairman will tell you in some cases has been the case with some groups that have come up here and said, we will take care of that later. And we all know what that means: It never gets taken care of.

Mr. KASICH. Thank you. I thank you, Mr. Chairman. I apologize to Mr. Kolbe and Mr. Stenholm for getting their time, and I appreciate it very much.

Chairman SMITH. Mr. Herger has a question.

Mr. KASICH. Oh.

Mr. HERGER. Mr. Chairman, I want to thank you for your involvement, for taking the effort to put forward a plan to help save Social Security. I guess my question is in this area of 45, what is it, 45 to 54, would be receiving something less than what they would be receiving now. And I know you are one of those who would be very willing to sacrifice that.

Mr. KASICH. Yes; just barely made the cutoff.

Mr. HERGER. I think of my town hall meetings and we all have these notch babies that come up, whether or not it is correct.

Mr. KASICH. Well, we know it is not correct.

Mr. HERGER. In their eyes. I still have them come forward, and I hope you have been more successful than I have.

Mr. KASICH. What I tell them is if you are a notch baby and you are complaining, we can treat you like everybody after the notch, and you will get less because you got phased in with a higher amount than is reflected in your wages. I just don't dabble around it. They are mad and I say, well, you know, you have got to get un-mad.

Mr. HERGER. Bless you for taking that head-on. I hope you have been more successful with those notch babies than I have been. My concern is that this group that we are setting up, do you feel that other than yourself and myself and some others, that this would be a political liability?

Mr. KASICH. Let me say something about the notch-year people. The reason why the notch-year people are so upset is that they think they literally got shafted, and there were people that wrote articles and drove this and drove this, and then folks out here making money by writing to these notch-year people and telling them what a terrible rip-off it is.

And people are fundamentally not selfish. You talk to the people who were the notch-year people, they are very concerned about their grandchildren, there is no question about it. And so you have to tell them the fact is that the system was going bankrupt. We did a phase-in period for you. And when they understand that and—see, the problem is I am a politician, so whatever I tell them, they don't believe me to begin with. If you tell them enough times, they start thinking about it and I think they can accept it. But the problem is they read it in the paper and then they listen to a politician, and there is a big gap there. That is the first thing.

The second thing is, do I think that people between 45 and 54 would be willing to do something? Let me tell you, Wally, Mr. Herger, I would be astounded if we were not. I would be absolutely astounded if we said, no, we would very much like to stand on the shoulders of our kids. I don't believe it. And I can tell you that when I travel and people know about this plan, they are very positive about it. They are glad somebody is laying out the facts and somebody is trying to do something.

And remember, even for people who are 45, look how many more retirement tools we have right now. And so we are not asking anybody to take a bludgeoning here. This is a tiny little give for significantly fixing the system and improving the quality of our children's lives. So would somebody write that somebody is a notch-year in 2025? Yeah, probably, if they are still having town hall meetings, and we might still have to go and explain this. And I will be old enough to be able to hobble into that room and say, let me tell you what I really meant to be doing here.

And I think it is something that this generation would be willing to do. I hope. If not, you tell me what the alternative is. The alternative is to whack everything or melt this program down or continue to put off what we know needs to be done? That is not acceptable.

Mr. HERGER. And that is certainly what the great debate is, and thank you very much. I yield to Mr. Collins.

Mr. COLLINS. This is a volunteer program; right?

Mr. KASICH. Correct. You can stay under the current system.

Mr. COLLINS. If you are not willing to give it up, you don't have to opt into this program?

Mr. KASICH. That is correct. Thank you, Mr. Chairman.

Chairman SMITH. Thank you, Mr. Chairman.

Mr. Kolbe and Mr. Stenholm, let me just say that in addition to the thank-yous for being here and developing a proposal, these two gentleman have headed up the Public Pension Reform Caucus for the last 5 years and probably have been the catalyst and burr under the saddle to move the discussion forward. So congratulations and please proceed.

STATEMENT OF THE HON. JIM KOLBE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Mr. KOLBE. Thank you, Mr. Chairman. I also want to commend Mr. Kasich, who has already left, for the contribution he has made. I think his plan and ours share a lot in common. They are both fiscally responsible and I think the Chairman of the Budget Committee has done a great deal to advance this debate.

Mr. Chairman, I appreciate your kind remarks about our efforts with the Public Pension Reform program because I hope it has helped to educate Members of both the House, Republican and Democratic Caucuses, and our staffs about it.

Congressman Stenholm and I have been working on this a long time, as have you Mr. Chairman, on your own proposal. And I am delighted that this Task Force is looking at this issue and recognizing the need for comprehensive Social Security reform.

We remain steadfast in our belief that comprehensive reform is possible in this Congress and this year. Now, the window of opportunity for doing it is closing very fast. And we respectfully submit to the committee that our legislation, though not perfect, we think can form a foundation for legislation which might be considered by Congress. You have a written copy of our statement. You also I believe have received a briefing book about our plan.

There are four specific issues that I think that I would like you to focus on with regard to our plan. One, how the Kolbe-Stenholm plan reduces Social Security's program costs to sustainable levels; second, why the Kolbe-Stenholm plan is a better deal for women than the current Social Security law; third, the property rights and opportunities for wealth creation under the Kolbe-Stenholm plan; fourth, why a carveout is absolutely necessary.

Because of the time constraints, I am only going to be able to address the first two of these issues. First, on the issue of sustainable costs. While restoring actuarial balance to the Social Security Trust Fund is an important step, it is only one measure of the financial stability of the Social Security reform plan. A truly responsible Social Security plan has to control the costs of the Social Security program over the long run, and it has to address the cash shortfalls that begin in 2014.

And I cannot emphasize that last point enough, Mr. Chairman. Not one plan, not yours, not ours, not Mr. Archer's not Mr. Kasich's, none of them deal entirely with the cash shortfall that exists in the year 2014 because the cash shortfall is so large. I think it is very important to keep that in mind.

And if you think the budget caps are tough now, imagine the budget pain that we will experience when the growth in Social Security and Medicare programs forces Congress to cut programs like NIH, cancer research grants, Pell grants, Meals on Wheels, any of those worthy programs that we all know about, by 15 percent or more, and that is what we are looking at. The day that that would happen is not that far in the future and that is why we have to act now. If we don't act now, the future is the present.

There are three ways to measure the financial stability of a Social Security reform plan: The impact on program costs; the plan's impact on annual cash flow deficits; the plan's impact on the national debt.

First, on the program costs, briefly. You have a chart and it is also in the packet of information up there. What are the average costs? We haven't been able to put the Kasich plan up there yet. Current law versus the Kolbe-Stenholm and the Archer somewhat, and you can see that ours is, over the 75 years, is better than any certainly current law. And Archer-Shaw and the peak costs—and this is important in terms of the incredible pain that you would suffer—under current law it is going to go to 19.6 over the next 7 years and then it just keeps on going, it keeps on rising; whereas ours levels off and we have a lower, much lower peak cost.

Cash flow deficits: No plan, as I mentioned, can eliminate that cash flow directly, but ours does more about doing that. Current law, cash deficit would be over $814 billion by the year 2030. Ours would be at $272 billion.

And finally on the national debt, during the years that Social Security is running cash flow deficits, the government is going to have to borrow money to pay benefits. The current law, there is no figure because it is bankrupt, so there is no limit on it. And ours is much, much less than that which has been proposed by some of the other plans.

Let me very briefly in my remaining time focus on the impact on women, because there are several provisions that are especially beneficial to women, and I don't think other plans have addressed that. The most notable is the minimum benefit provision which would provide a more robust benefit than is currently provided by current law. If you work for 40 years, you get a benefit that is 100 percent of poverty level. Under that provision alone, 50 percent of women will do better under our plan than current law. It allows for voluntary contributions, as I think you know. You can contribute, like an IRS, up to $2,000 additional in the account. So women who take time out to raise children can make voluntary contributions before and after the hiatus to catch up.

And women who are at the lower end of the economic scale, and more single women are in that category, there is a savings subsidy. For each dollar of a voluntary contribution you put in, you get a $150 match by the Federal Government, and each additional dollar is matched 50 percent, up to a cap of $600. And we provide a mechanism for doing that through the earned income tax credit.

One last thing about why women are going to do better under ours is the changing nature of divorce. Current law stipulates that a woman gets a benefit if her marriage lasts 10 years. She is entitled to 50 percent of her spouse's Social Security benefit. But divorce and marriage is changing. Whereas it used to be that marriages lasted longer and divorce occurred after 15 to 20 years of marriage, today it is most likely to occur in the fourth to seventh year of marriage, so a woman is not going to get any benefit today.

I think our plan does more in terms of helping women than the other plans have done. There is much more to be said about our plan, and I will turn to Mr. Stenholm to talk about some of those.

[The information referred to follows:]

PREPARED STATEMENT OF HON. JIM KOLBE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA, AND HON. CHARLES W. STENHOLM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Chairman Smith, Congresswoman Rivers and Members of the House Budget Committee Social Security Task Force, we appreciate the opportunity to appear here today to discuss Social Security reform and present our legislation for your consideration. We've spent several years working together on this issue and we are delighted that the Budget Committee recognizes the need to address the financial and demographics problems that threaten our nation's most successful anti-poverty program.

A few weeks ago, we testified before the Ways and Means Committee. Chairman Archer invited all sponsors of plans with 75-year solvency to address the Committee. We think 75-year solvency is a critical element of this debate. Groups on and off the Hill have suggested that this goal may be too ambitious, and that incremental reform may be a better solution. We disagree. It is for good reason current law mandates that the Social Security Trustees evaluate the health of the Trust Fund over a 75-year horizon. This period encompasses the entire future life span of all current workers and beneficiaries, including newborn babies—the beneficiaries of tomorrow. Also, the projection period is sufficient to evaluate the full effect of changes to the Social Security program.

In fact, we would like to see the Budget Committee set the bar even higher. We believe the Members also should consider the impact of reform proposals on the annual operating cash flow of the Federal Government, and on the Trust Fund balance at the end of the 75-year forecast horizon. Solvency alone is an incomplete standard for determining whether legislation truly strengthens Social Security. Solvency is not sufficient if we leave the Social Security system in a deteriorating condition at the end of the period, or if the Federal budget incurs massive cash deficits in the interim years.

The difference between a plan that leaves in place a strong and growing Trust Fund at the end of seventy-five years, and a plan that extends solvency for a finite period of time but leaves the system with a depleted Trust Fund, is fundamental and significant. The issue should not be 50 years versus 75 years, it should be whether a reform plan offers a complete solution that puts the Social Security system on a permanent, sustainable fiscal course.

A "partial" solution will only exacerbate the cynicism among young people that Social Security won't be there for them. A "partial" solution will require continuous "tinkering" and adjustment, impeding the ability of Americans to plan for retirement with a degree of certainty. Any credible reform plan must put the Trust Fund on a permanent path of financial stability that will ensure the system remains fiscally sound throughout the valuation period and beyond. Genuine solvency is achieved only if the cash flow is balanced, and the Trust Fund is stable and getting stronger at the end of the forecast period.

WE WERE COUNTRY WHEN COUNTRY WASN'T COOL

To paraphrase the country and western song, we were Social Security reformers before Social Security reform was cool. Three years ago, we came together to form the Public Pension Reform Caucus and begin a discussion in Congress. Today, the PPRC has a bipartisan membership of 75 members. Our goal was to educate ourselves and our colleagues about the issues and challenges facing Social Security. Perhaps just as importantly, we sought to demonstrate the type of centrist, bipartisan approach to the substance and politics of Social Security reform necessary to resolve the impending crisis.

Two years ago, we joined Senators Judd Gregg (R-NH) and John Breaux (D-LA) to serve as Congressional cochairmen of the CSIS National Commission on Retirement Policy (NCRP). The NCRP was a 24-member commission comprised of leaders from the business community and experts on retirement policy. Our goal was to develop a plan to strengthen America's retirement programs, including employer-provided pensions, personal savings and, finally, Social Security. Fifteen months after the panel's creation, we disproved the notion that all commissions must end in disagreement or irrelevance. In a unanimous vote, our commission agreed on the 21st Century Retirement Security Act.

We introduced legislation last Congress (H.R. 4824, 105th Congress) based on the NCRP report. That legislation generated considerable interest and praise for representing a fiscally responsible approach to strengthen the Social Security program. Since then, we have talked with many of our colleagues on both sides of the aisle, met with Administration's staff to discuss our proposal and listened to constructive criticisms of our plan. The legislation we bring before you today is a revised version of the NCRP plan—a "new and improved" plan that we believe addresses many of the concerns that have been brought to our attention over the last year.

H.R. 1793: THE 21ST CENTURY RETIREMENT SECURITY ACT

We still adhere to the same guiding principles as our previous legislation: a balanced, actuarially sound plan that reduces the $7.4 trillion unfunded liability, improves rates of return and strengthens the safety net. We accomplish this by using personal accounts to advance-fund future obligations and by implementing much needed structural reforms. We've softened some of the tough choices in last year's bill and included some new provisions aimed at improving the retirement income of the working poor. What we don't do, however, is rely on double counting, cost-shifting, uncertain budget surpluses and accounting gimmickry to hide the true costs of reform—unlike some "free lunch" plans that have been offered by the right and left.

Our legislation, The 21st Century Retirement Security Act, provides a payroll tax cut for all working individuals under the age of 55 by diverting 2 percent of FICA taxes into personal Individual Security Accounts. Workers also would be allowed to make additional voluntary contributions of up to $2,000 a year to their individual account. The legislation also provides a savings match for voluntary contributions to help low-income workers build their individual accounts.

The individual accounts in our plan would be modeled on the Federal Government's Thrift Savings Plan. In the TSP, individuals personally choose investment options, including a stock index fund, a bond index fund and a Treasury securities index fund. Unlike other proposals, our plan would provide individuals with ownership and control over their retirement assets, including the freedom to invest in safe, risk-free Treasury securities. We don't force anyone to invest their Social Security monies in the stock market—it's your money, your choice.

Our bill also strengthens traditional Social Security's safety net by creating a more substantial guaranteed minimum benefit that ensures stronger poverty protections than currently provided for low-income workers. Moreover, this benefit is given regardless of any other factors. Consequently, any income from the individual accounts would supplement the enhanced guaranteed Social Security benefit for low-income workers.

Our plan makes changes in the defined benefit program, but in a progressive manner that insulates vulnerable populations. Changes to the defined benefit largely affect mid-to-high income individuals who will benefit disproportionately from the individual accounts. We implement additional reforms that reduce the cost of the Social Security program. For example, our plan makes changes to reflect the increases in life expectancy and longer working lives, provides for a more accurate inflation adjustment, and rewards work. While these provisions involve some pain, it is necessary to make tough choices to ensure that future governments will have resources to deal with other problems in addition to Social Security.

We have never claimed that our plan is perfect. Every one of you could go through our plan and select individual items in the plan to criticize—either we went too far or not far enough. We remain open to constructive suggestions about how our plan can be improved. However, we encourage you to look at the plan "holistically"—to examine what the proposal accomplishes in it's entirety, rather than focus on one or two provisions. If everyone determines the acceptability or unacceptability of various proposals based on a single element, we'll never achieve the bipartisan consensus necessary to pass a bill and save Social Security.

KOLBE-STENHOLM IS A FOUNDATION PLAN

We respectfully suggest to this committee that the bipartisan work embodied by this legislation offers a foundation for you to commence negotiations and create meaningful, comprehensive reform that can be enacted in to law this year. There are several elements in our proposal that we believe are essential to reaching a bipartisan consensus on Social Security reform:

1. Bipartisan. Our proposal is a truly bipartisan solution that balances the objectives of different political perspectives.

2. Solvent. The legislation we introduced has been scored by the actuaries of the Social Security Administration as restoring solvency to the Social Security program for the next 75 years and beyond.

3. Fiscally responsible. Our legislation tackles the tough choices that are necessary to control cost and reduce the pressures on future general revenues. It does not use cost shifts or other accounting gimmickry and does not rely on projected surpluses to create new general fund liabilities.

4. Empowers all Americans. The legislation establishes individual accounts that provide all Americans the opportunity to create wealth, and provides individuals with ownership of and control over their retirement assets.

5. Enhances the safety net. Our legislation contains several provisions in both the defined benefit program and individual accounts that provide stronger poverty protections and greater assistance to low-income workers than are contained in current law.

6. Rewards work. The legislation makes several reforms to enhance the work incentives in the current system.

7. Improves Social Security for all Americans. Our proposal provides all future retirees with a better rate of return than the current system can afford, and protects all taxpayers from the increased tax burden created by the existing general fund obligations to the Social Security system.

THE KOLBE-STENHOLM PLAN IS BIPARTISAN

An agreement on legislation to strengthen Social Security will require bipartisan cooperation. We must put party affiliations aside and think about the future generations who will be affected by the decisions we make today.

The Kolbe-Stenholm plan is a model for building this bridge. The Social Security reform debate has been characterized as an either-or choice between two ideological poles—"status quo" or "full privatization." Defenders of the status quo argue that any reform that includes a market-based component will undermine the current safety net features and expose workers to dangerous risks. Advocates of full privatization suggest that the creation of privately managed personal accounts will painlessly solve every challenge while, in fact, they ignore existing long-term liabilities and the needs of special populations. Both extremes make for good, albeit myopic, rhetoric and fail to acknowledge the virtue of hybridization. The complete solution to the Social Security problem can and must combine the best of the traditional program with new market-based options.

Our plan attempts to balance three competing objectives we think are necessary to achieve a responsible consensus that can win the support of the left, right and middle of the Social Security debate. It establishes individual accounts to improve rates of return for all retirees—the key objective of most Republicans. At the same time, it maintains and strengthens the important protections that the Social Security system provides for low-income retirees, survivors and the disabled—the key objective of most Democrats. Last, but definitely not least, it honestly deals with the financial challenges of Social Security, the key concern of those of us in the radical center.

THE KOLBE-STENHOLM PLAN IS FISCALLY RESPONSIBLE—OR "SHOW ME THE MONEY!"

Our plan sets the standard for a credible, responsible solution to Social Security.

The 21st Century Retirement Act ensures the Social Security program will operate on a solid, sustainable fiscal path well into the next millennium. It does this by honestly and responsibly addressing the unfunded liabilities of the program.

Three distinguishing characteristics separate this plan from other prominent proposals. First, unlike the President's proposal, our plan restores the Social Security Trust Fund to 75-year actuarial balance. Second, unlike several "free lunch" proposals, our plan addresses the cash deficits that begin in 2014 (when benefit costs exceed payroll tax revenues), by reducing the pressure on general revenues and preserving the flexibility of future governments to meet other critical budget needs. Third, the 21st Century Retirement Security Act does not depend on projected budget surpluses, cost shifts or accounting gimmicks to balance the Social Security program.

The 21st Century Retirement Security Act restores solvency of the Social Security Trust Fund by eliminating the entire projected cash shortfall in the Trust Fund over the next 75 years. Moreover, it does so using conservative economic assumptions. Just as importantly, the 21st Century Retirement Security Act makes structural reforms to the Social Security system that help restore the traditional program to a path of long-term solvency that does not deteriorate over time. The Kolbe-Stenholm plan puts Social Security revenues and outlays on a sustainable course over the entire 75-year period. The Trust Fund ratio—the amount of cash reserves in the Trust Fund relative to projected benefits—is rising at the end of the 75-year period. Thus, there is no "cliff effect."

While restoring actuarial balance to the Social Security Trust Fund is an important step, it is only one measure of the financial stability of a Social Security reform plan. A truly responsible Social Security plan must control the costs of the Social Security program over the long term and address the cash shortfalls that will create tremendous liabilities on general revenues beginning in 2014. Controlling the costs of the Social Security system is essential to the fiscal health of our government. If we do not address the pressures on the rest of the budget caused by the growth in the costs of Social Security, future Congresses will be forced to cut other important government programs or raise additional taxes to meet the obligations to our senior citizens. Not only will there be no room for any domestic initiatives; we will have to cut back on existing programs to make room for growth in spending on Social Security

According to the Congressional Budget Office long-term budget projections, which assume that we will use 100 percent of projected surpluses to reduce our national debt, Social Security will consume an ever growing portion of the Federal budget, creating tremendous budgetary pressures. Between now and 2030, the percentage of our national income consumed by Social Security will increase by 50 percent. Spending on Social Security consumes slightly less than 20 percent of total Federal revenues today. CBO projects that Social Security will grow to 23.5 percent of total revenues by 2015 and nearly 30 percent of total revenues by 2030.

The tough choices we struggle with in the current appropriations cycle are mild compared to the problems we will leave for future Congresses if we do not take action now to control the costs of the Social Security program. By 2025, spending on programs other than Social Security and Medicare will have to be reduced by nearly 9 percent below current levels if we do not take action. By 2030, spending on programs other than Social Security and Medicare will have to be reduced by 16 percent below current levels.

Under current law, the U.S. Treasury must find $7.4 trillion in cash from general revenues between 2014 and 2034 to convert the IOUs in the Social Security Trust Fund into cash benefits for Social Security recipients. These general fund liabilities will be more than $200 billion a year by 2020 and more than $800 billion in 2030 alone. After adjusting for inflation, the amount of general revenues that will need to be provided to the Social Security system in 2030 to provide promised benefits will be greater than total non-defense discretionary spending last year.

The 21st Century Retirement Security Act restores the costs of the Social Security system to sustainable levels. According the Social Security Administration actuaries, the costs of the Social Security system will average 14.0 percent of payroll over the 75-year period under our plan, compared to 16.4 percent under current law. The costs of the Social Security system will never exceed 15.7 percent of payroll under our plan. Under current law, the costs of the Social Security system will reach 19.6 percent of payroll by 2075 and will continue growing. Our proposal and the Senate bipartisan proposal will do more to control the costs of the Social Security system than any other proposal. In fact, several prominent proposals that have been put forward would actually result in higher costs for the Social Security system than the projected costs under current law (see Table 1).

TABLE 1.—COMPARISON OF COST RATES OF CURRENT LAW AND ALTERNATIVE PLANS

[As a percent of Taxable Payroll]

Year	Current law	Archer-Shaw	Senate bipartisan	Kolbe-Stenholm	Gramm	Stark
2000	10.8	12.8	12.7	12.9	15.0	10.8
2005	11.2	13.3	13.2	13.0	15.2	11.2
2010	11.9	13.9	13.4	13.4	15.6	11.9
2015	13.3	15.0	14.0	14.0	16.4	13.3
2020	15.0	16.4	14.7	14.8	17.3	15.0
2025	16.6	17.4	15.4	15.6	17.6	16.6
2030	17.7	17.8	15.7	15.7	17.1	17.7
2035	18.2	17.3	15.5	15.2	16.4	18.2
2040	18.2	16.2	14.8	14.5	15.2	18.2
2045	18.2	14.9	14.3	13.8	14.1	18.2
2050	18.3	13.8	13.9	13.3	13.4	18.3
2055	18.6	13.1	13.7	13.2	13.0	18.6

TABLE 1.—COMPARISON OF COST RATES OF CURRENT LAW AND ALTERNATIVE PLANS—Continued

[As a percent of Taxable Payroll]

Year	Current law	Archer-Shaw	Senate bipartisan	Kolbe-Stenholm	Gramm	Stark
2060	19.1	12.6	13.7	13.2	12.8	19.1
2065	19.4	12.3	13.6	13.4	12.5	19.4
2070	19.6	12.1	13.5	13.7	12.4	19.6
Minimum	10.8	12.1	12.7	12.9	12.4	10.8
Maximum	19.6	17.8	15.7	15.7	17.6	19.6
Average	16.4	14.6	14.1	14.0	14.9	16.4

Source: Office of the Actuary, Social Security Administration. Archer-Shaw plan memo dated April 29, 1999; Senate Bipartisan plan memo dated June 3, 1999; Kolbe-Stenholm plan memo dated May 25, 1999; and Gramm plan memo dated April 16, 1999. Nadler plan memo unavailable on date of publication.

Because our plan advance-funds future liabilities and addresses tough choices, it will dramatically reduce the general fund liabilities that exist under current law. By contrast, the leading plans proposed from the left and the right leave this liability in place and actually increase these general fund liabilities for the next fifty years. According to estimates prepared by the Social Security administration actuaries, the 21st Century Retirement Security Act would reduce the $7.4 trillion liability facing general revenues between 2014 and 2034 by approximately $3.8 trillion, a reduction of more than 50 percent. It would reduce the amount that the Federal Government will have to come up with from general revenues in 2025 from $420 billion to $217 billion. In 2030, our plan would reduce the burden on general revenues by more than half a trillion dollars, reducing a $814 billion liability to just $272 billion.

These reductions represent resources that will be available for other priorities, including programs for education, training, health care, debt reduction or tax cuts. The tough choices that are contained in our plan to control program costs must be viewed in context of the resources that would be freed for other priorities. Likewise, any evaluation of "free lunch" plans that claim to save Social Security without tackling tough choices must consider the problems these plans shunt onto the rest of the budget—problems that will be left for future Congresses. We can responsibly tackle some tough choices today or we can leave a fiscal time bomb for future generations. A plan that restores the Social Security Trust Fund to 75-year actuarial balance, but does not address the budgetary pressures created by these growing costs and general fund liabilities, does no favors for future generations.

Unlike other Social Security reform plans that are dependent upon funding from projected surpluses, the 21st Century Retirement Security Act is entirely self-financed and will achieve its goals whether or not current surplus projections are accurate. Although our plan relies on general revenue transfers, all of the general revenue transfers in our plan are paid for by savings in the non-Social Security budget from the CPI recapture provision. Plans which rely on general revenue transfers financed by projected surpluses either place the solvency of the Social Security Trust Fund in jeopardy, or create problems in the non-Social Security budget if the surpluses are not as large as currently projected. Under our plan, if the surpluses do materialize, they would remain available for debt reduction, strengthening Medicare, tax cuts, or spending on other priorities.

The 21st Century Retirement Security Act does not rely on double-counting, optimistic assumptions or other gimmicks to make the plan appear balanced on paper. The plan does not mask the costs of the program by shifting costs to other areas of the budget or the private economy. All payroll taxes are used only once, either to fund current benefits, fund individual accounts, or credit the Trust Fund. Unlike other plans, the Kolbe-Stenholm plan does not use Social Security surpluses already credited to the Social Security Trust Fund to justify a second round of credits to the Trust Fund. Nor does the plan pay for individual accounts with funds that already have been credited to the Trust Fund, like some "free lunch" plans do.

We learned a long time ago that if something sounds too good to be true, it probably is. There is no free lunch. We cannot afford to meet all of the promises in current law without finding additional resources elsewhere. Proponents of plans that claim to preserve benefits at levels promised under current law, or even suggest that benefits will be increased above current law, must answer the call "Show me the money!" Where does the money come from to fund these promises? These so-called "free lunch" plans which suggest it is possible to save Social Security without any pain actually have tremendous hidden costs that will require very real pain. They will drain the Federal budget and U.S. economy of resources that are needed for other government programs. They will result in higher tax burdens and lower national savings. Congress and the President must honestly address the fiscal challenges posed by the Social Security system, instead of ignoring hidden costs and pretending that we can meet these challenges without tough choices.

H.R. 1793 Empowers All Americans With Freedom and Control Over Their Retirement Assets

H.R. 1793 creates individual accounts based on the Federal employees' Thrift Savings Plan. This model combines the benefits of individual ownership with the protections offered by a quasi-private board governing fund managers. The TSP model offers a straight-forward, low-cost retirement savings mechanism safeguarded against fraud and abuse. The Thrift Savings Plan has been an extremely successful program for all Federal employees, including Members of Congress. The burden of record-keeping for each individual account would be assumed by the Board. Employer burdens and administrative costs would be kept to a minimum. The administrative costs would be spread across accounts proportionally based on account balances to limit the impact of administrative charges on small accounts.

Under our legislation, every worker would be able to choose from among a number of investment options selected by a quasi-private Board based on a competitive bidding process. Workers would have the opportunity to choose between options with higher risk and the potential of a commensurate higher return and those that are safer, with lower rates of return. The options would include a stock index fund, a bond index fund, and a government securities fund. No worker would be forced to put his or her retirement funds in the stock market. Workers would have the opportunity to select their own risk profile, including the freedom to invest in safe, risk free Treasury securities. Conversely, workers who want to take advantage of stock market returns could place all or most of their account in stock funds. The individual accounts under our plan are based on a simple philosophy: it's your money, your choice.

Opponents of individual accounts highlight examples of poorly implemented individual account systems in other countries that resulted in high administrative costs. There are legitimate administrative cost concerns about purely privatized individual account plans involving dozens of private account managers. However, these concerns can be addressed without eliminating individual control and turning investment decisions over to the government. Our legislation demonstrates that it is possible to give individuals control over their retirement income while also providing government safeguards that address legitimate risk concerns.

Federal Reserve Board Chairman Alan Greenspan and others have made a persuasive case about the risks of social investing, government interference in the market and conflicts of interest inherent in having the Trust Fund invested by the government in the stock market. Most significantly, though, the collective investment approach doesn't address the central impetus behind calls for individual accounts: taxpayers want their own stake in the economy and more control over their retirement benefits.

Critics argue that individual accounts are too risky for lower-income individuals. We believe that it is more risky, and certainly unfair, not to give lower-income individuals the opportunity to realize the benefits of accumulating assets. It is precisely this lack of investment opportunity that has left too many Americans on the fringe of the economy. Our legislation gives low-income workers the same opportunities to have savings for their retirement and reap the benefits of investment earnings that are already available to higher earning workers who benefit from 401(k) plans and other private savings vehicles. For low-income people, the individual security accounts are a pure bonus above and beyond the strengthened safety net provided by the guaranteed minimum benefit provision included in our legislation.

Why a Carve-Out is Necessary

H.R. 1793 creates individual accounts within the existing payroll tax structure instead of creating individual accounts above the current 12.4 percent payroll taxes. Some plans "add on" personal accounts through explicit or implicit tax increases or by diverting revenues from other programs. Diverting a portion of payroll taxes to create individual accounts—sometimes referred to as a "carve-out"—has been criticized as weakening the financial status of the Social Security system and requiring deeper benefit cuts than otherwise would be necessary. This argument completely ignores the benefits of using individual accounts funded with current payroll taxes to replace a portion of future unfunded liabilities instead of building up Trust Fund assets.

By placing a portion of current payroll taxes into individual accounts that will be available to provide retirement income for future retirees, our legislation would significantly reduce future unfunded benefit promises without reducing retirement income for these retirees. Under our plan, a portion of retirement income for future retirees will come from payroll taxes collected today and placed in individual accounts, instead of leaving the entire burden of funding retirement income to future taxpayers. The large reductions in future liabilities on general revenues that we outlined earlier in our statement are possible because of the advance funding from creating individual accounts with existing payroll taxes.

While there has been a lot of discussion about the transition costs of creating individual accounts, the transition costs resulting from advance funding future benefits must be viewed in context of the reductions in future liabilities that are achieved by this advance funding. Proposals which rely on increasing the balances of the Social Security Trust Fund to meet future benefit promises—instead of creating individual accounts—effectively leave the financial burden of providing retirement income for future retirees to future taxpayers. The transition costs of creating individual accounts out of existing payroll taxes are much smaller than the liabilities that future taxpayers will face in redeeming trust fund balances under current law. Those who criticize plans to advance fund future benefits with individual accounts because of the transition costs resulting from diverting a portion of current payroll taxes should be asked to explain how they plan to meet the general fund liabilities that would be reduced under our plan. Our legislation takes responsibility for itself and preserves the flexibility of future Americans to address other national needs.

There have been some suggestions that creating individual accounts outside of the existing payroll taxes—sometimes referred to as an "add-on"—would represent a compromise on the issue of individual accounts. We strongly disagree with that suggestion. In fact, creating individual accounts above the existing payroll tax would actually exacerbate the concerns that we have outlined about the budgetary pressures that will be created by retirement programs under current law. That would represent a major step backwards from current law, not a compromise.

Since there is very little willingness to explicitly require additional contributions above the current 12.4 percent payroll tax rate to fund individual accounts, most proposals that create individual accounts outside of the current payroll tax are funded with general revenues from projected surpluses. This approach presents some very serious problems in terms of fiscal responsibility, future tax burdens and resources available for other needs. Even if projected surpluses materialize as currently estimated—an uncertain prospect at best—they will not last indefinitely. However, the obligation to fund individual accounts from general revenues would be permanent.

A Congressional Budget Office analysis of one such plan to create individual accounts with general revenues warned that this approach would result in higher implicit tax burdens, increased budgetary pressures and a higher national debt. The Social Security Actuaries have found that creating individual accounts of 2 percent funded with general revenues could increase the national debt by more than $10 trillion above current projections over the next thirty years. Creating individual accounts outside of the existing 12.4 percent payroll tax means higher tax burdens on future generations, less resources available for all other government priorities, and higher debt. We cannot afford to ignore the very serious fiscal consequences that this approach would have in the future in order to meet political needs of today.

The real question isn't whether or not a plan has individual accounts, it is whether the plan uses the individual accounts to address future liabilities to taxpayers. Unlike plans which use current payroll taxes to prefund future benefits instead of building IOUs in the Trust Fund, individual accounts funded outside of the current payroll tax would allow the Trust Fund to continue to accumulate IOUs. These IOUs are merely claims against future general revenues. Using current payroll taxes to create individual accounts and advance fund future benefits will substantially reduce the liabilities on future general revenues. By contrast, individual accounts added on top of the current system take funds from general revenues today and leave in place the future liabilities on general revenues. This is a fundamental difference from a fiscal perspective that must not be brushed aside to reach a political compromise.

THE KOLBE-STENHOLM PLAN STRENGTHENS THE GOVERNMENT SAFETY NET

The 21st Century Retirement Security Act restores the solvency of the Social Security Trust Fund in a way that not only protects low-income workers from any reduction in benefits, it actually strengthens the safety net provided by the Social Security program. It contains a new minimum benefit provision that offers stronger poverty protection than provided under current law. The plan also provides a subsidy to supplement the individual accounts of low-income workers. Finally, by addressing the unfunded liabilities of the Social Security without shifting new obligations onto general revenues, our plan reduces the pressure to cut funding for other government programs that benefit low-income populations.

One of the innovative features of our bill is a minimum benefit provision that provides a much stronger safety net for low and moderate-income workers when they retire than is contained in current law. An individual who has worked for 40 years and qualified for 40 years of coverage will be guaranteed a Social Security benefit equal to 100 percent of the poverty level. Workers would be eligible for a minimum benefit equal to 60 percent of poverty after 20 years of work, and the minimum benefit would increase by 2 percent of the poverty level for each additional year of work. This minimum benefit level is calculated without regard to any other change in the benefit formula under our legislation. Any income from the individual accounts would supplement this guaranteed benefit. Widows would be covered by the minimum benefit guarantee based on his or her spouse's work history.

The new minimum benefit provision will enable Social Security to lift more of the elderly out of poverty than current law. Currently, nearly 8 million seniors receive benefits that are less than the poverty level. According to the Social Security Administration actuaries, 50 percent of women and 10 percent of men would receive higher guaranteed Social Security benefits as a result of the minimum benefit provision in H.R. 1793. For a low-wage worker, defined by the Social Security Administration as a worker with lifetime earnings equal to 45 percent of the national median, the minimum benefit provision increases retirement income by more than 10 percent (see Table 2)—not including any balances that would accrue in the worker's personal account. We say to all Americans—if you work all your life and play by the rules, you won't retire into poverty.

The Kolbe-Stenholm plan also incorporates the concept from the President's USA proposal of helping low-income workers save for their retirement by providing subsidies for workers. The individual accounts in the 21st Century Retirement Security Act will give low and moderate income workers the opportunity to benefit from investment opportunities that higher income workers already have with 401(k) plans, IRAs and mutual funds. To help low-income workers take advantage of this new savings vehicle the Kolbe-Stenholm plan provides a savings subsidy, or "match" for low-income workers who make voluntary contributions to their individual account. A maximum of $600 per individual is allowed per year. To qualify for the subsidy in any given year, an individual must earn less than $30,000 per year and make at least $1 in voluntary contributions to their personal account. The subsidy for low income workers will help increase retirement savings for lower income workers who do not have access to private pensions and have little or no other savings for retirement.

TABLE 2.—IMPACT OF THE MINIMUM BENEFIT PROVISION ON A LOW-WAGE WORKER

Low-wage worker earning 45% of the National Average Wage (per year)	$12,600
CURRENT LAW SOCIAL SECURITY BENEFIT	
Social Security Benefit at Normal Retirement Age:	$568
Plus: Spousal Benefit (if applicable):	$284
Equals: Total Monthly Social Security Benefit:	$852
SOCIAL SECURITY BENEFIT UNDER KOLBE-STENHOLM	
Poverty Level for a single-person household over age 65 (per year)	$7,525
Translated into a monthly benefit (divide by 12)	$627
Plus: Spousal Benefit (if applicable)	$314
Equals: Total Monthly Social Security Benefit [1]	$941
Kolbe-Stenholm increase over current law benefits (per month)	10.4% / $89

[1] This amount does not include any balances that accrue in the workers personal account. Consequently, total benefits will be higher.

We've discussed in detail the reduction in the unfunded liabilities of the Social Security system under our proposal. This effect is substantial for low-income individuals as well, because the budgetary pressures that will occur under current law threaten deep cuts in other safety net programs that benefit low-income populations. By honestly addressing the budgetary pressures created by the unfunded liabilities of the Social Security system, our plan ensures that future governments will have resources available to preserve funding for discretionary spending and other programs that benefit low-income families in addition to providing Social Security benefits.

Instead of focusing on rhetoric about what Social Security reform could do to vulnerable populations, we encourage you to look closely at what our plan actually does. The 21st Century Retirement Security Act demonstrates that a fiscally responsible plan to strengthen the Social Security system and create individual accounts with existing payroll taxes can actually preserve and strengthen the safety net provided by Social Security.

THE KOLBE-STENHOLM PLAN INCREASES NATIONAL SAVINGS

It is a basic rule of economics that increasing national savings is vital to maintaining a strong and growing economy. Comprehensive Social Security reform, done properly, could be the most significant action the government could take to increase national savings. Estelle James, a World Bank Economist who has studied retirement systems and across the world and served on the NCRP, wrote in a study of public pension reforms around the world that:

"* * * a change from the old traditional pay-as-you-go, defined-benefit type of Social Security system to a system that includes more funding, more individual accounts, and a closer link between benefits and contributions is good for the overall economy * * * It helps all countries develop their long-term saving, which seems to be linked to economic growth."

The 21st Century Retirement Security Act contains several features that will help increase national savings. By advance funding a portion of future benefits and tackling the tough choices necessary to control the cots of the Social Security system, our plan dramatically reduces the unfunded liabilities that will place a tremendous drain on national savings in the future. The individual accounts in our plan create a new vehicle for increased retirement savings by allowing workers to make voluntary contributions of up to $2000 a year to their individual accounts. The savings match for low-income workers will provide low-income workers with an incentive and assistance to save for their own retirement. The reductions in the defined benefits for the middle and upper income workers who have the means to save for their own retirement will encourage these workers to increase their private retirement savings. The Congressional Budget Office and several economic studies have found that the existence of high guaranteed benefit levels for higher income workers has the effect of reducing private savings among these workers.

THE KOLBE-STENHOLM PLAN IS A BETTER DEAL FOR ALL AMERICANS

When all of the provisions of the 21st Century Retirement Security Act are taken into consideration, it offers a much better deal for all Americans than current law. Our plan will put into place a Social Security system that will remain financially strong for the next 75 years and beyond, and reduces the tax burdens that will be necessary to support the system. At the same time, the legislation we have introduced will provide a better rate of return than can be provided under current law and strengthens the safety net for low-income workers. The individual accounts in our plan will allow all workers to create wealth and benefit from market forces. Perhaps most importantly, our plan will help restore public confidence in the future of the Social Security system.

Our legislation increases the rate of return for all workers compared to what current law can fund. Comparing the benefits under our plan to the benefits promised under current law is extremely misleading, because we cannot afford the benefits promised under current law. Today, the Social Security system faces a funding gap that must be closed if beneficiaries are to be protected. Eliminating the funding shortfall under current law through a traditional package of benefit reductions or tax increases would exacerbate the bad deal that Americans receive from Social Security.

Under current law, benefits will have to be cut by more than 25 percent after 2034 unless we raise payroll taxes. If the burden of closing this funding gap were spread evenly among all generations, benefit levels would be cut by nearly 16 percent beginning immediately. To accurately compare our plan to the benefits promised under current law, it is necessary to consider the substantially higher tax burdens that will be necessary to fund the benefits promised under current law. To the extent that current law promises higher benefit levels than our plan can deliver for some middle and upper income retirees, it can only meet those promises by imposing much higher taxes on those workers. When the benefits promised under current law are viewed in context of the taxes that must be raised to fund those benefit promises, the deal offered by current law is not nearly as attractive for today's workers. When all of the benefits under 21st Century Retirement Security Act are compared to what current law can actually deliver, future retirees will get a much better deal under our legislation than they would under current law.

Our legislation establishes the opportunity for all Americans to create wealth and benefit from the market forces to increase their retirement income. Individual accounts will extend to low and moderate income workers the investment opportunities that higher income workers with 401(k) plans and mutual funds already enjoy. Unlike the current system and some other individual account plans, H.R. 1793 will provide individuals with ownership of and control over their retirement assets.

Finally, the 21st Century Retirement Security Act will improve public confidence in the future of the Social Security system. The Social Security system has a well-deserved reputation as one of the most successful government programs in history, and has enjoyed strong public support. However, the financial problems facing the system and the low-rate of return that current workers can expect to receive on their payroll taxes threatens to undermine this support. The plan we have introduced offers a message of reassurance to seniors and a message of hope to younger generations.

Our plan reassures seniors that the long-term challenges facing Social Security can be addressed without threatening the benefits they have been promised. Our bill restores the solvency of the Social Security system while preserving existing benefit promises for current and near-retirees. Current retirees would continue to receive their existing benefits, with full increases for inflation, accurately measured. By putting the Social Security system on a sustainable fiscal path, our plan protects current retirees from the threat of benefit changes that may be necessary if the Social Security system continues to face financial problems.

While it is important that Social Security reform protect the interests of current retirees, it is just as important that we address the concerns of younger generations that doubt that the Social Security system will be there for them. The Social Security system has always been based on an implicit generational contract that workers will pay taxes to fund benefits for current retirees in the expectation that they will receive similar benefits when they retire. This generational contract is threatened by the growing skepticism among younger workers about the future of the Social Security system. Requiring workers to pay taxes to support a system that they do not expect to benefit from will create discord that can only jeopardize the political legitimacy of the Social Security program.

The 21st Century Retirement Security Act will give younger generations much greater confidence in the Social Security system. Our plan reassures younger generations that the Social Security program will be there for them when they retire by putting the system on a long-term, sustainable fiscal path. In addition, our legislation will give younger workers ownership of and control over a portion of their retirement income, providing them with concrete assurance that the Social Security system will provide them with retirement income. Our legislation will modernize the Social Security system to ensure that it can earn the support of younger generations that will be necessary to preserve the program.

Congress Must Not Shirk Its Responsibilities in Exchange for Political Expediency

We realize that reaching agreement on an honest solution to the long-term challenges facing Social Security will be difficult, but the difficulty of the task must not prevent us from confronting it. Social Security reform will require us to tackle tough choices. We were elected to make tough choices, and our constituents deserve no less from us.

We hope that the suggestions contained in the legislation we have presented to you will help create a foundation to build a bipartisan agreement on Social Security reform. While our legislation may not be perfect, it does offer all of the elements that will be necessary for a responsible bipartisan deal to strengthen the Social Security system.

We do not agree with those who say that the issue of Social Security reform is dead. These hearings are evidence that the issue remains very much alive. More importantly, those of us who have the honor of serving in public office have an obligation to keep this issue alive for the sake of future generations that are counting on this system. As we tackle the tough choices that will be necessary to enact credible Social Security reforms, we must look beyond current polls and think about how our children and grandchildren will look back at the decisions we make today. We look forward to working with this Committee to create a future for the Social Security system that will make future generations grateful for the decisions we make today.

STATEMENT OF THE HON. CHARLES W. STENHOLM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. STENHOLM. I too, Mr. Chairman, thank you for your efforts and leadership on this subject on which you hold the hearings today. And I also commend Chairman Kasich for the approach which he has taken, which Jim has mentioned bears some similarities to the program and the proposal that he has briefly described part of, and I want to concentrate on the fiscal responsibility side of the question today, being fitting that this is the Budget Committee.

The hallmark of our plan is honestly addressing the financial problems facing Social Security and tackling the tough choices that are necessary. And we don't do all of what needs to be done, but we do a heck of a lot more than most of the other plans.

Restoring solvency of the trust fund is important, but simply restoring solvency over 75 years is not enough. There are some basic questions that all of us need to ask who care about fiscal responsibility that should be asked of any Social Security plan being put forward.

One, does the plan put the Social Security System on a permanent sustainable course that will continue to remain strong at the end of the estimating period? Or does it leave the trust fund in a deteriorating condition at the end of the period? Does the plan deal with the tremendous liabilities on general revenue that will squeeze the rest of the budget beginning by 2014? And here I would emphasize very strongly, unless we as a Congress are prepared to deal with the 2014 problem, we had better be extremely conservative in the amount of taxes that we cut, and spending that we increase that just happen to begin at the end of a 15-year estimating window.

We have been through this. I served on this committee with Mr. Kolbe for many years, and we were always a little skeptical and very critical of administrations that were always estimating in the sixth year of a 5-year plan, or were estimating 5 years but not moving forward and looking at what would happen in the sixth and seventh.

I would encourage this committee to spend a considerable amount of time looking at the 2014 problem. And using that, first off, as you look at our chart—I assume we have got the one up that shows the red area here—we would have that amount of money available for cutting taxes if you do that which we suggest.

If you cannot do that which we suggest, then you had better come up with another way of dealing with that red area, because between now and 2032, the percentage of our national income consumed by Social Security will increase by 50 percent.

According to CBO's long-term budget projections, spending on Social Security consumes slightly less than 20 percent of total budget revenue today. It will grow to 30 percent by 2030. There will be no room for any domestic initiatives and we will have to cut back on existing programs or borrow the money beginning in 2014 if we do not make some additional choices that both Mr. Kasich and we talk about today.

There is no free lunch. The promised benefit under Social Security will cost $20 trillion more than we can afford over the next 75 years. That money will have to come from somewhere. Comparing the benefits of any reform plan to the benefits promised under current law is unfair because current law makes promises we cannot keep. Plans which suggest we can save Social Security without any tough choices depend on taking funds away from other government priorities in order to provide promised Social Security benefits.

Our plan does more than any other plan to reduce the long-term budgetary problems facing Social Security. Our plan makes some tough choices today that will require some sacrifices. We either make the tough choices today to honestly deal with the financial challenge facing Social Security or we leave a fiscal time bomb for future generations to deal with.

Our plan reduces the liability that Social Security will place on general revenues between 2014 and 2034 by more than 50 percent, reducing a $7.4 trillion liability by more than $3.8 trillion. Reducing those liabilities will provide future generations with the flexibility to deal with other problems in addition to preserving the Social Security system.

I point out again, the area in the red on the chart is money that will be available for other programs, whether it is money for education or agriculture or health care or defense or tax cuts or any other priorities that we may have in the future, but only if we make the decisions that we are talking about today.

And the final thing I would want to emphasize is what we believe is one of the strong points of our plan, is the changes we make to strengthen the safety net for those in the lower income levels. Our plan restores the solvency of the Social Security Trust Fund in a way that not only protects low-income workers from a reduction in benefits, but actually strengthens the safety net provided by the Social Security program.

The benefit changes in our plan primarily affect middle- and upper-income workers who will benefit from individual accounts. The new minimum benefit provision of our plan will enable Social Security to lift more of the elderly out of poverty than current law.

As you heard, 50 percent of women and 10 percent of men would receive higher guaranteed Social Security benefits as a result of the minimum benefit provision in our bill. A low-wage earner, defined by the Social Security Administration as a worker with earnings equal to 45 percent of the national average, would have a 10 percent increase in guaranteed benefits from our minimum benefit.

Under our proposal, no individual who works a full career will have to retire in poverty. Currently, nearly 8 million seniors receive benefits that are less than the poverty level. We say to all Americans, if you work all of your life and play by the rules, you won't retire into poverty.

Thank you, Mr. Chairman.

Chairman SMITH. Gentlemen, thank you very much. I guess one concern that I have is the unpredictable nature of demographics. We have had witnesses before this Task Force that suggested that within 40 years you would almost have the option of whether you wanted to live to 100 or 120, so I criticized the scoring for only 75 years. And the more that your plan is based on promising fixed benefits rather than fixed contributions, the more danger there is in future insolvency, depending on demographics and depending on a lot of the other issues that might face our economy.

So my question is: Have you considered the possibility, and why have you ruled out never going above a 2 percent private savings account?

Mr. KOLBE. Well, my answer would be I would never say never to that. But let's get this system in place and see how something in the future might change to be able to phase that in. As far as the demographics are concerned, I recognize that medical technology and other things are changing. But I don't know how else you can go about scoring a plan if you don't use a common base of data and information; and ours, of course, does use both the Social Security actuarial information and the Congressional Budget Office scoring mechanisms.

Chairman SMITH. But the problem with the 75-year scoring is that you take advantage of the existing 800 billion in the Social Security Trust Fund now and assume that that is going to come in and make the program more safe for retirement.

Mr. KOLBE. I will let Charlie respond, but ours really does not do that. Although we don't attempt to go beyond 75 years, our projections are that ours continues on a level, stable basis after 75 years. And certainly, there is far more volatility to go with the parts of scoring a Social Security plan in terms of wages and incomes and economic growth than—that is far more unstable than anything dealing with the demographics would be.

Mr. STENHOLM. I would just say that under the scoring that we have, and I believe our charts show that the Social Security Trust Fund is actually improving in its solvency at the end of our 75-year projection, and you will find that many others, that is not the case. But your point is very relevant.

I am uncomfortable with projecting 2 years, much less 75 years, with any kind of accuracy. And that is why we will continue to emphasize, both in this forum and others, being conservative with the utilization of 15-year estimates for purposes of making short-term, politically very popular decisions, whether it be in Social Security or otherwise.

And the reason we came up with 2 percent, it was the number that we could fit within what we believed to be a fiscally responsible approach, but it doesn't say it can't go up. If it works as well as we hope it does, there can be future adjustments and changes made. But we think you need to crawl before you walk before you run. And this one fits and others have a difficult time fitting within the fiscal responsibility criteria that we put upon our plan.

Chairman SMITH. I just want to make sure that you know I am a cosponsor of this. It moves us ahead. It has got tremendous value.

Mr. KOLBE. And we appreciate that.

Chairman SMITH. I am somewhat concerned and don't understand the full impact of the additional income tax that would be paid over the next 75 years, considering that the change in the CPI becomes compounded in terms of its total effect on the bracket creep and on deductions. Comments?

Mr. STENHOLM. Well, yeah, CPI change is not a tax increase or a benefit cut. It is a decrease in the rate of growth in Federal expenditures by making adjustments for inflation accuracy. The purpose of indexing benefits under Social Security and other programs in the provision of the Tax Code is to hold folks harmless from inflation. Our bill simply provides that we do so with accurate measures of inflation. And for those who argue this is a tax increase, show me where we change the tax rate and show me where we expand the base or increase the rate, because I can't find them in my bill, Mr. Chairman.

Chairman SMITH. The actuaries credit some of that money from tax savings going back into Social Security for your plan. So there is some tax benefit that is credited back to your plan as I read the actuaries's report.

Mr. STENHOLM. But it is based on an accurate estimation of what cost of living is. And how can you argue against trying to make it accurate, whether it is on spending increases or tax cuts?

Mr. KOLBE. Because I would note that it would also affect, for example, your Medicare premiums which would not rise as rapidly, so there is that factor too.

Chairman SMITH. Mr. Collins.

Mr. COLLINS. Mr. Chairman, I don't really have any questions but I do want to thank the two gentlemen for coming forward with a plan. Once again we have demonstrated that Members of Congress are willing to step up to the plate and offer an idea and proposal and put it forth for the American people to see. That is more than I can say about some folks in this town. Thank you.

Mr. KOLBE. Thank you very much.

Chairman SMITH. Jim, Charlie, do you have any specific suggestions on any other efforts that we might take, or your evaluation of moving this debate forward to increase the possibility or probability, that we can accomplish a bill?

Mr. KOLBE. Well, Mr. Chairman, I still believe, despite the rosy news yesterday about budget surpluses being better than anybody had anticipated over the next several years, I still believe we are clearly up against a budget caps problem this fall. And as Members of Congress become aware of that, and they then link that to the lockbox legislation that we passed here in the House not too long ago, I think they are going to come to the realization that the only way to solve our dilemma, both politically and economically, is to unlock that lockbox by doing something with Social Security. Once we solve Social Security, we free up the surplus that is in there for whatever spending we need this year, the tax cuts we need this year. We can do that. We cannot do it until we resolve Social Security.

Our goal as members of our Task Force and your Task Force, and our bill and all the other bills, should be to convince our colleagues that they need to deal with this now, because it is the key to solving the other political dilemmas that they face this fall. Otherwise we are headed for one heck of a massive train wreck this fall.

Mr. STENHOLM. Mr. Chairman, if I might add to that, I think we don't pretend that this plan is the perfect plan, and we stand ready to work with any individuals on both sides of the aisle and the administration to continue to develop a plan that can get the required number of votes and support. Our plan has one thing that only one other plan—and you heard from it earlier today—and that is the Senate plan that Senator Gregg and Senator Breaux brought forward, but ours is the only one that has bipartisan support, and nothing will happen except with bipartisan support.

So anything, Mr. Chairman, that you can do to continue to promote the bipartisanship and moving forward will be very helpful.

One of the things that we didn't mention, but we have asked CBO to score our plan on a 10-year basis, which is the longest that CBO scores things of this nature. And we don't have those numbers as yet, but I would hope, I would add, that in any actions that we take—because I happen to agree with Mr. Kolbe's statement regarding the caps problem this year, and the fact that the considerably more rosy scenario that we heard yesterday, it is all very good. But one of the best things we can do with these surpluses until we deal with Social Security and Medicare in a very rational way is apply it to the debt. Avoid the temptation to spend this money we have for tax cuts that explode in 2014 and create tremendous problems for Social Security, and by the same token avoid the temptation to spend more on the spending side. That is what we can do and what this committee can continue to provide the leadership to do.

Chairman SMITH. Gentlemen, thank you very much. Mr. Collins will preside, and I will go to that table to make a presentation of my Social Security bill.

Mr. COLLINS [presiding]. Mr. Smith—that is Mr. Chairman, the committee will now "endure" your testimony. So if you will begin and pay real close attention to the lights, sir.

STATEMENT OF THE HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Chairman SMITH. Yes, sir. This is the third scored Social Security bill that I have introduced. I started writing it in 1994, and it takes into account several, what I think are dynamic ideas about our future economy and to the survival of the Social Security system.

First, let me say that we cannot just deal with Social Security alone, without considering Medicare and what we do on Medicare, because both of these problems are important; and to take one without the other means that the eventual retirement security is going to be less secure.

This legislation, number one, allows workers to own and invest a portion of their Social Security taxes by creating these personal retirement savings accounts. I start at 2.6 percent—Mr. Chairman, gosh, that seemed so quick.

Mr. COLLINS. Glad you are paying attention to the lights.

Chairman SMITH. I start at 2.6 percent of payroll and that 2.6 percent of taxable payroll increases over the next 60 years to 8.4 percent. In other words, I move Social Security—except for the 4.2 percent that is reserved for the safety net and the disabled and their dependents, into a private system.

The 2.6 percent eventually can go as high as 8.4 percent. It only takes 5.4 percent over a period of 30 years to have a return on those investments greater than what current Social Security promises.

So under all of these plans, an individual that is able to invest in their own accounts for over 25 years has a significant advantage over current promises of Social Security.

I come up with funding in several ways. One is I take on-budget surpluses for 8 years, not to exceed Social Security surplus revenues, to help support investment in those early years. Secondly, I index the retirement age to life expectancy after the person reaches the retirement age of 67 under current law.

The PRSAs, the personal retirement savings accounts, in my first bill were given the same restrictions as IRAs. A lot of individuals need to know more about investing, because we have failed in educating our young people and we need to start doing that. My legislation simplifies the investment choices by limiting participants to about the same options you have under the thrift savings program, index stocks, index bonds, index small cap funds and index global funds. It uses the surpluses coming into the Social Security Trust Fund to finance these. There is no increase in taxes or government borrowing. The PRSA accounts can be taken out for individuals that want to retire early, so anybody that has enough PRSA savings or other savings and can buy an annuity to guarantee taxpayers that they are not going to come back on taxpayers later on for welfare benefits or other Social Security benefits, can retire at any time.

So we are suggesting that the age of retirement with PRSAs is much more flexible. Workers are encouraged to invest by allowing an individual to invest with the same tax benefits as Social Security; in other words, only taxing half of it. They can put up to an additional $2,000 a year in their PRSA account. The tax incentives, I think, will help spur additional savings.

This proposal gradually slows down the benefits for high-income workers by changing the bend points. John Kasich suggested the problem of indexing the bend points and indexing what retirees are going to get. Under the current law it is indexed to wage inflation that is higher than CPI. So for our first bill in 1994, when we were writing it, we brought this back to CPI inflation rather than wage inflation, which slows down the increase in benefits for the higher income, precisely because we only change the second and third bend points. We don't change the wage inflation index for the first bend point. Therefore, it slows down benefits for higher-income recipients.

We have several advantages to women in our bill. One, we divide the personal savings account equally between husband and wife. In other words, we add both spouses individual contributions together, then divide by two, so both the wife and the husband can invest in their own personal retirement savings account the exact same amount of dollars. Also, we increase the minimum benefit for surviving spouses to 110 percent over the 100 percent that is now in current law. This has been scored by the Social Security Administration to keep Social Security solvent, but because we gradually over the years increase the amount allowed to go into that personal retirement savings account, it is going to stay solvent forever, not just the 75 years calculated by the SSA actuaries. It maintains a trust fund reserve continually, so we always have at least one-half year's Social Security benefits in that trust fund.

I think it is the kind of proposal that faces up to the challenges ahead of us. I would be glad to respond to any questions.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

As a member of the 104th Congress, I introduced the first reform plan in the House this decade that provided private retirements savings accounts and was scored to keep Social Security solvent. That bill, "The Social Security Solvency Act of 1996," was updated and re-introduced as "The Social Security Solvency Act of 1997." Shortly, I will introduce "The Social Security Solvency Act of 1999."

Today, I would like to use the lessons we have learned during our months of fact-finding on the Task Force to argue in favor of my "Social Security Solvency Act of 1999," which I will introduce shortly. Although there are some important refinements, this Act is patterned on the "Social Security Solvency Act of 1997" that I introduced previously. Like the 1997 bill, it has been scored by the actuaries as restoring the solvency of America's most popular public program. The development of my plan follows from what I consider to be the Ten Commandments of Social Security reform.

THE TEN COMMANDMENTS FOR SOCIAL SECURITY REFORMERS

The first commandment is that time is our enemy and we must move without delay. Alan Greenspan informed us in March that OASDI has an unfunded open liability of $9 trillion 1999 dollars. This means that an outside party would require an up-front payment of $9 trillion now, plus the legal right to 12.4 percent of 85 percent of the nation's payroll forever just to honor the promises we have made to present and future retirees, survivors, and disabled individuals. This obligation is very real, and it exceeds by almost three times the size of the national debt held by the public. Every year we delay, this unfunded liability goes up by hundreds of billions of dollars as we grow closer to the day when Social Security's temporary positive cash flow first halts, then stops forever.

Put another way, to keep Social Security solvent for just the next 75 years, it would take an across-the-board cut in Social Security benefits of 14 percent for current or all future beneficiaries to make up the shortfall if we act now. Alternatively, a 16 percent increase in Social Security taxes would also eliminate the shortfall. These representative figures will get larger the longer we delay.

In 1983, the Congress felt an urgent need to act when Social Security had an unfunded liability of −1.82 percent of taxable payroll. The system now has an unfunded liability of −2.07 percent, a problem that is 15 percent larger than the one in 1983! With the danger so high, we must act with at least the same sense of urgency. Anyone who says we have the luxury of time to tackle this difficult subject is committing the nation to wrenching changes later rather than less dramatic corrections now.

The second commandment is that we must reform the system to take into account the growing probability of a significant rise in life expectancy. Dramatic increases in life spans is wonderful news. Dr. Kenneth Manton, one of America's most respected demographers, told the Task Force to expect to see many of our next generation celebrating their 100th birthday. Dr. William Haseltine, a recognized expert on aging and regenerative biology and President of a company that expects to complete mapping the human genome in the next few years, thinks that science will make even greater advances. He believes that many of our children will live to 120. As life expectancy increases, we must create opportunities for our elderly population to remain productive and active long into that period of life we now call "retirement."

Third, we should move prudently but boldly. Our actions must equal the scope of the problem before us. Fortunately, it is now possible to solve our problems by making gradual and continual Solvency. It took 60 years to create the current crisis. We can resolve it in steady measured steps over 40 years.

The fourth commandment is that the burden of adjustment must fall equitably. Any change should hold current retirees harmless. They should receive full cost-of-living increases. Those near their retirement years and low income workers should also be protected. Meanwhile, better paid workers should contribute more than those with moderate incomes.

The fifth commandment states that no tax increases should be adopted to eliminate Social Security's unfunded liability. Medicare has very difficult problems, and added revenue will be needed to resolve them. Its unfunded liability is twice that of Social Security. Social Security reformers who use new tax revenue to solve their problems complicate efforts to resolve Medicare's difficulties—where lives, not dollars, are at stake.

The sixth commandment holds that every worker should enjoy the benefits of saving and investing. A primary reason why the rich are outpacing the lower and middle classes is their ability to invest in thriving corporations that yield returns that significantly exceed those received by putting funds in banks. Professor Roger Ibbotson, the nation's foremost historian on stock and fixed income markets, predicted in 1974 that the Dow would rise from 1,000 to 10,000 by the year 2000. He now projects that the Dow will reach 100,000 before 2025. A way must be found so that everyone can get a share of this $140 trillion in new wealth that will be created.

The seventh commandment dictates that investments made for retirement must be prudent. Prudent risk-taking does not require that every investment turn out brilliantly. It does require that no matter what happens every retiree have adequate funds from Social Security to remain above the poverty level.

The eighth commandment declares that professional money managers should not earn excessive fees from carrying out an essential national mission. The Task Force heard from William Shipman, a Principal of State Street Global Research, who presented the firm's detailed administrative cost model. Workers can have access to broadly diversified stock and bonds portfolios for only pennies a day. The GAO is confirming these findings, and will publish its report before the end of the month.

The ninth commandment compels us to redesign social security so that it commands full public confidence. Currently, many workers have so little faith in the System that they view their payroll taxes, not a contributions for their own retirement but, as sacrifices. While they support helping seniors, they don't personally expect to receive checks when they become seniors themselves. Social Security will never be free from political peril until all workers view participation as a valuable fringe benefit from going to work.

The tenth commandment requires us to maintain our lead in a competitive global economy. Other nations are modernizing their national retirement systems. If we fail to improve ours, it will hurt our national economic performance and our standing in the world. Countries that have prepared themselves for the coming demographic changes will have strong economies that vault them ahead of their global competitors. I want the U.S. to be among that group of world economy leaders.

If you agree with these principles, you will like my plan. It is derived from them.

THE MOST ESSENTIAL STEP: CREATING PERSONAL RETIREMENT SAVINGS ACCOUNTS (PRSAs)

The central element of my plan is to provide all workers with Personal Retirement Savings Accounts (PRSAs) that they own and are professionally invested solely for their benefit. For the next 36 years all workers will contribute 2.6 percent of their pay, up to the maximum Social Security wage base, into their accounts. Individuals will choose where to invest these funds but will be offered attractive low cost, high reward, equity and fixed income index funds as well as more specialized programs if they so choose. After 2036, the actuaries say the contribution rate can rapidly climb, reaching 11 percent by 2074.

Here are some examples of PRSAs in action. A 20-year old worker earning $20,000 will deposit $520 the first year. Assuming a 2.5 percent inflation rate and she earns a pay raise 3.5 percent annually, the annual contributions will grow over time reaching $3,944 forty-five years from now. Over 45 years, she will place a total of $62,800 in her account. Assuming her funds were placed in an equity index fund that earned a 6.5 percent real rate of return, this $62,800 will grow to $422,000—4.6 times her final salary. By converting this sum into an annuity, she can expect to receive $34,500 a year for 19 years after her retirement. I choose that time period because it is how long the actuaries assume in their Social Security projections.

The amount that better-off workers will have in their accounts is proportionate. A teacher starting at $30,000 will see her account grow to $633,000, and her annual benefits for 19 years will be $51,750. A young attorney graduating from a fine law school who lands a job at $60,000 will retire a millionaire, having $1,266,000 in her account, and see annual benefits of $103,500 for 19 years.

Here are representative figures for 40 year old workers. A worker earning $20,000 today will have $59,200 in her PRSA account at 65. A $30,000 per year bus driver will have $88,800. The 40 year middle management executive will hold $177,600. These workers will see their annual retirement incomes supplemented by $5,000, $7,500, and $15,000 when the PSRAs are converted into annuities good until the anticipated time of death.

Finally, here are figures for 55 year old workers. The grocery clerk earning $20,000 now will acquire a $9,000 PRSA in 10 years. The bank teller earing $30,000 now will have $15,600 while the successful architect earning $60,000 now will have $27,000 in 2010.

The point of these examples is that PRSAs grow very rapidly under the magic of compound interest. The biggest beneficiaries of PSRAs are the young and future generations. It makes sense, therefore, to take this into account when allocating costs across generations for restoring the System.

INVESTMENT RISK CAN BE MANAGED

Fears about sudden stock market tumbles are overblown. It will be 20 years or more before the amounts at risk represent significant sums as a percentage of the resources needed to ensure a secure retirement. Put another way, even with a 2.6 percent "carve out" of Social Security payroll taxes, it will be far into the future before the monthly private retirement check exceeds the check received from Social Security. We will have time to evaluate investment returns and account for unexpected events that jeopardize workers retirement security long before they could happen. These fears should not prevent us from instituting needed reforms today.

I am exploring ways to reassure workers who may not have had experience with 401(k) plans or mutual funds. Although the number of happy investors has reached an all time high along with the DOW, the process may seem frightening to those who haven't personally benefited from the Reagan-Bush-Clinton bull market. One idea that I would encourage the Committee to explore is a formal guarantee that anyone 45 or under will be guaranteed a retirement income equal to current law benefits provided they invest their PSRAs in equity investments. We know from 200 years of stock market history that equity returns over long periods outperform all other prudent investments. Consequently, the government can offer guarantees to long term investors with confidence that there is at least a 200 to 1 chance it will never be called upon to honor them. I haven't had this provision scored by the actuaries. Therefore, I cannot present it to you in a formal way.

There are other ways cautious investors can avoid risk. First, they can transfer the risk of market downturns to others who accept it voluntarily. There are many life insurance and annuity products that do just that. Insurance companies are professional risk takers, and are quite successful at it. Many annuity investors give up the chance for large gains, but they avoid losses in exchange. Here's another example. Right now, a large investment house offers the public for a fee a bundle of equities with the right to sell it back to them at the price you paid for it 5 years from now. As Will Rogers once said, "Sometime the important thing isn't the return on capital. It's the return of capital."

When introduced, my bill will include an elimination of the earnings test for retirees. I believe the benefits of encouraging Americans to stay in the work force will strengthen Social Security in the long run.

PAYING FOR IT

An important issue that any reformer must confront is how to finance the transition to a modern system. We start deep in the hole with a $9 trillion unfunded liability. The problem becomes harder when 2.6 percent or more of taxable payroll is channeled into PRSAs, the earnings test is repealed, and widows benefits expanded by 10 percent as I propose.

Fortunately, the problem can be resolved under a policy of "easy does it" and "steady as she goes." My answer is to slow down the growth of benefits by a small amount each year for a long time. Under currently law, OASDI benefits will increase by 90 percent, after inflation, over the next 75 years. If we agree that real benefits should grow at a slower rate, then we can solve this problem.

My bill does this by amending the benefit formula. Before presenting my amendments, I wish to first review how initial Social Security benefit checks are determined. Under current law, a worker at normal retirement age earns a monthly benefit check known as the "primary insurance amount" or PIA. The PIA is calculated in steps. First, a worker's entire earnings record, from teenage years to retirement, is updated for inflation. Then, only the highest earning 35 years are isolated. Next, these best earning years are averaged to get an average annual earnings level. Finally, this total is divided by 12 to get "Average Indexed Monthly Earnings" or AIME.

Social Security is often described as a progressive program. The reason for this belief is that the PIA is derived from AIME in a progressive way. In 1999, anyone with an AIME of $505 or less, the equivalent of only $6,060 in year, will receive 90 percent of this amount annually. Anyone with an AIME of $3,043 will receive

90 percent of the first $505 of AIME, then 32 percent of the remaining amount. Anyone with an AIME in excess of $3,043 will receive 90 percent of the first $505 of AIME, 32 percent of the next $2,538, and only 15 percent of any remaining amounts. As you can see, Social Security provides 90 percent of the earnings of a very low paid worker's historic pay while only 42 percent of workers who averaged earnings of $36,000. The wage replacement percentage dips lower for the best off participants. The 1999 dollar thresholds of $505 and $3,043 where the benefit rates shift are known as "bend points." Under current law, they are annually increased by changes in average nominal wages.

I propose to make the Social Security system more progressive by slowing down the growth rate of benefits for those in the 32 percent and 15 percent benefit brackets. I do this first by phasing in a 5 percent bracket over 5 years that only the highest paid workers would face. It would start at AIME above $3,720 if fully in effect today. Next, I propose that the 5 percent and 15 percent brackets gradually decline at a 2.5 percent rate. In the first adjustment year for example, they would be 4.875 (5 x 0.975) and 31.2 percent (32 x 0.975). Five years out they would be 4.41 (5 x 0.985 x 0.985 x 0.985 x 0.985 x 0.985) and 28.2 percent (32 x 0.985 x 0.985 x 0.985 x 0.985 x 0.985). I propose that the 32 percent rate also decline but by only 2 percent a year, not 2.5 percent. I want the lowest paid workers to be unaffected or unambiguously better off from my changes. Consequently, the 90 percent rate is not subject to reduction.

As a further way to slow down the growth rate in real benefits, I proposed that the 15 percent and 5 percent bend points, and their future derivative rates, be indexed to changes in the CPI, not nominal wages. The bend point that defines the 90 percent AIME credit level will continue to rise with nominal wages.

I believe the mechanism under my bill, which generates a very gradual change annual change over a long period of time is a fair way to allocate the costs across generations and income levels. It's true that high school kids and young workers today would make the largest contributions to solvency. However, as we saw earlier, they have the time to benefit from the magic of compound interest. The two payment streams, one from Social Security, the other from PRSAs, together will exceed the amount of benefits projected under current law just from Social Security.

It's worth remarking that our youngest workers have the least faith that they will ever receive a Social Security benefit. In one famous poll, a larger number said they believed in UFOs than they would collect Social Security. Young workers will especially like having a binding property right in their own privately managed PRSA while giving up only some of a Social Security benefit many never expect to see in the first place.

Gradually Raising the Retirement Age as Life Expectancy at Age 65 Rapidly Improves

There are two other reforms required to restore Social Security to long-term health. The first requires thinking through a pleasant subject, increasing life expectancy during our retirement years. The actuaries predict that newborn children today who reach 65 years of age will live 3 years longer than those who reach that age now. The difference in life expectancy works out to about 1/2 additional month of life for every passing year. This means an infant born today who reaches his 65th birthday can expect to live until 85.5, compared to 82.5 today.

I propose that we all share our good fortune of living longer with the taxpayers. After all, we'll have more time to prepare for it! I propose eliminating the 11 year hiatus in current law between 2005–16 where the retirement age remains at 66 before increasing in 2 month increments in 2017 to 2021. Instead, I recommend raising it to 67 by 2010, then indexing it to life expectancy. The indexing provision may be the most important idea in the bill if the Task Force experts prove prescient and our children and grandchildren are destined to led much longer lives than we. Reflecting on the age of this Committee's venerable Chairman and my upcoming 65th birthday, I think the vast majority of future workers, who can be expected to be in better shape than we are today, are up to the task. For those who are not, we should update the disability program. For those who want to retire early, we should let them do so, as is now done, with actuarially fair reduced benefits.

Sharing the PRSA Bounty With the Taxpayers

As the size of PRSAs grows, the need for taxpayer assistance declines. We can ask for an especially large contribution from that young attorney who will have a PRSA worth over $1,000,000 for example. I propose that PRSA accounts be offset by the future value of contributions made into PRSA assuming a 3.7 percent real rate of return. In effect, a worker who gets a 6.5 percent real rate of return from equity investments will keep 2.8 percent. The remaining 3.7 percent is returned to the Trust Funds so they balance. A 2.8 percent real rate of return is much higher than the 1 percent or less experts now predict on future OASDI payroll tax payments if, and it's a big if, Congress finds a way to honor all benefit promises under current law. I wish it could be higher. But as Billy Joel sang, "We didn't start the fire. It's been burning since the world been turning." We have to eliminate the $9 trillion shortfall we've been handed or leave a more difficult challenge to future leaders who will lead if we refuse the challenge.

ACTUARIAL SCORING OF THE SOCIAL SECURITY SOLVENCY ACT

Here is the summary table the Social Security actuaries.

ESTIMATED LONG-RANGE OASDI FINANCIAL EFFECT OF PROPOSAL OF REPRESENTATIVE NICK SMITH

Section		Estimated change in long-range OASDI actuarial balance[1]
201	Raise the NRA by 2 months per year for those age 62 in 2000 to 2011, then index to maintain a constant ratio of expected retirement years to potential work years	0.50
202	Provide a third PIA bend point in 2000 with a 5 percent percent factor; index the second and third bend points by the CPI and gradually phase down the 32, 15 and 5 percent factors after 2000	2.89
203	Annual statement for workers and beneficiaries	([2])
205	Cover under OASDI all State and local government employees hired after 2000	0.21
206	Increase benefit payable to all surviving spouses by 10 percent beginning 2001	−0.30
207	SSA study the feasibility of optional participation	([2])
	Subtotal for sections 201, 202, 203, 205, 206, 207	3.21
101	Set up PRSA accounts starting 2001.	
102	Redirect 2.6 percentage points of OASDI payroll tax to PRSAs for 2001–2036. After 2036, redirect to PRSAs any OASDI income in excess of the amount needed to cover annual program costs and maintain a minimal contingency reserve trust fund. Transfer specified amounts from the Treasury to OASDI for years 2001–9 (based on current CBO surplus est).	
103	Reduce OASI benefit levels by the amount of lifetime PRSA contributions, accumulated at the yield on trust fund assets plus 0.7 percent	−1.15
	Total for proposal	2.06

[1] Estimates for individual provisions exclude interaction.
[2] Negligible, i.e., less than 0.005 percent of payroll.

Notes: Based on the intermediate assumptions of the 1999 Annual Trustees Report, Office of the Chief Actuary, Social Security Administration, June 5, 1999.

THE IMPACT OF THE PLAN ON THE UNIFIED BUDGET

The Social Security Solvency Act has a very salutary effect on the long run unified budget. Under current law, the nation will experience a dramatic swing in the unified budget over the next sixty years. Until most of the baby boomers retire around 2020, the nation can expect to run unified budget surpluses. For the fifty years or longer that follow 2020, the unified budget will plunge into the red with accelerating speed. My bill helps to stabilize the unified budget over the long run by reducing the size of surpluses now and reducing the size of the deficits that appear after 2020. The bill principally reduces unified surpluses now by channeling a portion of payroll receipts into PSRAs. By amending the benefits formula, it reduces unified budget deficits significantly later on. Overall, my bill makes the government smaller. Both taxes and spending as a share of GDP fall significantly in the middle of the next century.

My bill's primary impact in the early years is to reduce revenues by 2.6 percent of taxable payroll, starting in 2001. Table II F7 of the Social Security 1999 Trustees Report specifies how much revenue, by year, 12.4 percent of taxable payroll tax raises for the several years. By calculating what fraction 2.6 is of 12.4, then multiplying by projected taxable payroll receipts its possible to calculate how much the bill reduces revenues. We estimate these revenue reductions will be offset by $12 billion annually by 2008 by bringing newly hired state and local government workers under Social Security.

My bill provides for a 10 percent increase in widows/widower benefits, which will increase Social Security outlays. Short term outlays also will increase because less

Federal debt will be retired due to the revenue reductions and outlays increases, resulting in higher interest expenses.

Gradual reduction in benefits, due to indexing the bend points to the CPI rather than nominal wages, and gradual phasing down the 32 percent, 15 percent, and 5 percent benefit factors, will reduce outlays by growing amounts. Benefits are further reduced through the 3.7 percent offset formula described above.

The combined impact of all these changes is shown in the following table:

IMPACT OF THE MAJOR PROVISIONS OF THE SOCIAL SECURITY SOLVENCY ACT ON THE UNIFIED BUDGET

[Dollars in billions]

Year	Debt	Widow/Widower	Benefits	Total outlays	Revenues	Impact on unified budget
2001	+$5	+$9	−$1	+$13	−$95	−$108
2002	+9	+9	−3	+15	−97	−112
2003	+14	+9	−4	+19	−100	−119
2004	+19	+9	−6	+22	−104	−126
2005	+24	+10	−9	+25	−109	−134
2006	+29	+10	−14	+25	−113	−138
2007	+34	+10	−19	+25	−117	−142
2008	+39	+10	−25	+24	−122	−146
Total	....	....	....	+205	−857	−1,025

To comply with reconciliation instructions, the Committee could elect to defer some contributions into PRSA accounts from 2001–4 until 2005–8. Additional revenue would have to be found since estimated revenue losses total $857 billion from 2000 to 2008 while the instruction limits reductions to $778 billion from 2000 to 2009. Spending offsets will be needed to pay for the widow's benefit.

THE ACT PREVENTS DANGEROUS FUTURE UNIFIED BUDGET DEFICITS

PERCENT OF TAXABLE PAYROLL

Year	Current law income rate	Current law cost rate	Annual balance	Smith bill income rate	Smith bill Cost rate	Annual balance
2010	12.75	11.91	.84	10.13	11.30	−1.18
2020	12.91	15.03	−2.12	10.22	11.86	−1.63
2030	13.09	17.71	−4.62	10.33	11.98	−1.65
2040	13.17	18.18	−5.00	9.62	9.85	−0.23
2050	13.22	18.28	−5.06	7.10	7.26	−0.17
2060	13.29	19.05	−5.77	5.02	5.14	−0.12
2070	13.34	19.63	−6.29	3.09	3.18	−0.09

After 2015, my bill substantially reduces future unified budget deficits. The precise amounts are difficult to calculate 15, 25, or 50 years out. However, their magnitude can be suggested from the actuaries' scoring. Under current law, the 1999 Trustees Report found that OASDI would run deficits starting in 2015 by growing amounts. By 2040, OASDI will run deficits equal to 5.00 percent of taxable payroll and growing. Under my plan, OASDI will run only a minor deficit of 0.23 percent of taxable payroll, and it will be falling. Here is a comparison of the two actuarial projections. It proves that my bill avoids the creation of massive unified deficits for most of the 21st century. It therefore stabilizes long-run fiscal policy.

IMPACT ON THE SOCIAL SECURITY TRUST FUNDS

Instead of exhausting the Trust Funds in 2035, my plan keeps them in the black.

[Percentages]

Year	Trust fund ratio	Year	Trust fund ratio	Year	Trust fund ratio
2005	241	2035	54	2065	49
2015	267	2045	45	2074	68
2025	159	2055	45		

Note: The Trust Fund Ratio equals the amount of assets on hand divided by that year's disbursements.

USE OF GENERAL REVENUES

I believe solving Social Security's problems is so important we should apply the proceeds from of on-budget surpluses from 2000 until 2008 to achieve it. Importantly, the plan still provides room for tax relief, improving Medicare's unstable financing, or a reduction in the national debt.

SMITH PLAN REDUCES, BUT DOES NOT ELIMINATE, SHORT-TERM UNIFIED BUDGET SURPLUSES

[Dollars in billions]

Year	2001	2002	2003	2004	2005	2006	2007	2008
Off-Budget	$145	$153	$161	$171	$183	$193	$204	$212
On Budget	6	55	48	63	72	113	130	143
Smith Plan	−107	−111	−118	−125	−132	−137	−141	−146
Remaining Surplus	+44	+98	+91	+109	+123	+169	+193	+209

Every day of delay leaves us with fewer resources to bring solvency to Social Security. Right now, the system is enjoying robust surpluses. In fifteen years, these surpluses will be gone, replaced by deficits that grow larger each year. We must act now for the baby boomers' retirement.

CONGRESSMAN NICK SMITH'S SOCIAL SECURITY SOLVENCY ACT: A TAX CUT FOR WORKERS

- Allows workers to own and invest a portion of their Social Security taxes by creating Personal Retirement Savings Accounts (PRSAs).
- PRSA investment starts at 2.5 percent of wages (20 percent of Social Security taxes) and gradually increases.
- PRSA limited to a variety of safe investments.
- Uses surpluses coming into the Social Security Trust Fund to finance PRSAs.
- No increases in taxes or government borrowing.
- PRSA account withdrawals may begin at 59½, while the eligibility age for fixed benefits is gradually increased by 2 years over current law.
- Tax incentive for workers to invest an additional $2,000 each year.
- Gradually slows down benefit increases for high income retirees.
- Divides PRSA contributions between couples to protect non-working spouses.
- Widows or widowers benefit increased to 110 percent of standard benefit payment.
- Scored by the Social Security Administration to keep Social Security solvent.
- Maintains a Trust Fund reserve.

Mr. COLLINS. Is this an option, or does this 2.6 percent apply to all?

Chairman SMITH. It is optional when you go into the program. But here again if you are expecting to receive a return on your private investments of 4 percent or more, then in the long run it is going to be an advantage to go into the program. So the way it is scored by Social Security is assuming that everybody is going into the program, but in our legislation it is optional.

Mr. COLLINS. How about age? Is there any age limitation to opt into it?

Chairman SMITH. No age limitation. In fact, what we do, Mac, is we also require the Social Security trustees to start looking at ways individuals can totally opt out of Social Security if they want to. That is going to be somewhat expensive, but at least it seemed reasonable for younger people to have some way of opting out of Social Security if they wanted to, except we wouldn't allow them to opt out of the disability insurance portion of the program.

Mr. COLLINS. Do I understand that someone age 61 could opt into this?

Chairman SMITH. Yes, any age can opt into it. Of course, the people who are really going to benefit are those who can keep that private investment in there for 20 years or 25 years. Then the magic of compound interest is going to give you a much higher benefit in relation to what you can now get under Social Security.

Mr. COLLINS. What age maximum is the least benefit to opt into it; 55, 60?

Chairman SMITH. If you can get a 5 or 6 percent real return, then you should opt into it at any age because, No. 1, it becomes your account. If you happen to die before retirement, you are getting all of that personal retirement savings, unlike the current Social Security system that leaves you with nothing. In terms of what future Congresses might do, because the Supreme Court has ruled twice now that there is no entitlement for benefits regardless of what you pay in Social Security taxes, then I think once people understand the consequences, most everybody is going to opt into the program unless they are ready to retire in the next year or two.

So maybe, if I were answering your question specifically, I would say anybody that was under 60 might find an advantage in coming into this program.

Mr. COLLINS. You have two spouses working, both the husband and wife. The wife makes $30,000 a year. The husband makes $60,000. You mentioned something about you treat them equal?

Chairman SMITH. Yes. I take 2.6 percent to start out. In the early years it is 2.6 percent. Ultimately it gets to 8.4 percent. In the early years 2.6 percent times 30,000 plus 2.6 percent times 60,000 are added together, so each spouse, each husband and wife, would have the exact same amount to invest in their personal retirement account. It might reduce some of the business for attorneys in case there is ever a divorce because it has been equally divided while they are married. Then the division and equal investment would, of course, stop, but it is all accounted for in terms of if there is a divorce or something else happens plus the fairness of having it equally in both names.

Mr. COLLINS. Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

Mr. Smith, a couple of questions. First I want to start by saying I think this is a tremendous plan, extremely thoughtful in detail, and it accomplishes a number of things. Is it fair to say that the goal of your plan is to gradually transition to a fully funded, fully prefunded system of personal savings accounts, and with respect to the retirement portion of Social Security, that is your goal to profoundly transform the nature of this system?

Chairman SMITH. That is the goal. And if you can get a real return of more than 3.7 percent, then you are going to be ahead of fixed benefits. What we did do is we saved out almost 4 percent in the current plan. I am not sure what is going to happen to the disability insurance portion of the program. Since that has grown so tremendously, we wanted to save enough aside there to make sure it is covered.

Mr. TOOMEY. By using 4 percent you are using more than twice of what it would currently cost to finance that part of it?

Chairman SMITH. The financing now is 1.7 percent.

Mr. TOOMEY. As far as ownership of the plans go, does your plan contemplate complete ownership, by which I mean—first of all, do you force annuitization?

Chairman SMITH. Yes, we force annuitization so that the fixed portion of benefits plus the annuity would equal ultimate Social Security benefits.

Mr. TOOMEY. So the forced annuitization would only apply to that amount of the savings account which is necessary to generate that minimum savings; is that correct? Anything above and beyond that a person would be free to do with as they please?

Chairman SMITH. Correct.

Mr. TOOMEY. As far as investment options, do I understand you correctly to say that you would limit them to index funds?

Chairman SMITH. Yes. We limit them to four choices. Now, we add sort of a fifth option directing the Secretary of Treasury to add any other investment account allowances that he thinks is appropriate that are less risky investments.

Ultimately it seems to me that we have got to start training our young kids about investment if they are going to be able to enjoy the wealth creation that investment can accomplish. I would like to incorporate in my bill, but I can't very well do it, that we start training these kids in high school to excite them about the magic of compound interest and investments, but eventually I think it is important that we expand that to a broader range of investments.

Mr. TOOMEY. Right. I agree with that sense.

As far as the reduction in fixed benefits, if I understand correctly, you apply a calculation equivalent of a theoretical annuitization based on 3.7 percent assumed return to the savings account, and that is the amount by which you would reduce the fixed benefit portion?

Chairman SMITH. Technically in the bill we add what Treasury's 30-year treasuries are getting plus 0.7 percent. That amounts to 3.7 percent. Your offset of your fixed benefits would equal 3.7 percent of your personal retirement savings account.

Mr. TOOMEY. That is a fixed amount. You don't contemplate that fluctuating with respect to some market index or anything?

Chairman SMITH. No, I don't.

Mr. TOOMEY. The administration of accounts like this we have heard a lot of discussion over the course of our hearing. Some believe that it is absolutely impossible. Some have made reasonably compelling arguments that they have got a system for this. Do you advocate using an approach similar to what State Street recommended using?

Chairman SMITH. Yes, we include the State Street type of approach in our bill.

Mr. TOOMEY. Last question. The—using CPI versus wages to determine initial benefits, you mention you do that with an application of two out of the three bend points, not the first, as Chairman Kasich approaches it, with all three of the bend points. Is that primarily to keep the system more progressive, or does that have the net effect of keeping the system more progressive or less, or does it not——

Chairman SMITH. It has the effect of keeping the system more progressive so the low- and moderate-wage individuals would continue to have their benefits grow faster than the higher-income recipients.

Mr. TOOMEY. If you applied it to all three bend points, as Chairman Kasich does, there would still be an element of progressivity in the program, correct?

Chairman SMITH. There would be some progressivity. Mr. Kasich, as I understand his proposal, offsets the disadvantage of changing the bend point for—the first bend point by allowing a higher percentage of investment for those low income.

Mr. TOOMEY. Thank you very much.

Mr. COLLINS. One other question, Chairman Smith. If I understand your proposal here, you don't have any transfer payments built into this as was presented by the memos from the other end of the hall; is that correct?

Chairman SMITH. I do have transfer payments. I call on general fund surpluses not to exceed Social Security surpluses to help in the transition. Also, what we will be doing in the bill is we are using the Social Security surplus to pay down the debt and to reduce any negative effects for any recipients regardless of their age. We are going to look for the general fund to contribute the amount of interest savings to try to make sure that nobody is disadvantaged, even that vulnerable age group from 45 to 60.

Mr. COLLINS. But by transfer payment, you are not setting up, you are not requiring above the current tax rate any additional funds? I know it is going to take general funds to bail out any——

Chairman SMITH. No.

Mr. COLLINS. You are not setting up a kitty account; you are not setting up a personal account that takes money beyond the current tax system?

Chairman SMITH. No, except we do call on money coming in from the general fund to a certain extent.

Mr. COLLINS. You have a safety net?

Chairman SMITH. And then we have a safety net, yes.

Mr. COLLINS. Thank you.

Chairman SMITH. Thank you.

Mr. COLLINS. Any further questions for this gentleman?

Mr. TOOMEY. Not at the present time.

Mr. COLLINS. Stand in reserve in case some question comes up, please.

Chairman SMITH. You may mail me questions.

Mr. COLLINS. We expect a full answer, too.

Chairman SMITH. Mr. DeFazio, I think, is next.

Mr. COLLINS. Mr. DeFazio.

Chairman SMITH [presiding]. Mr. Roscoe Bartlett.

Mr. BARTLETT. Mr. Markey should be here to testify with me. We are checking to see if he is on his way.

Chairman SMITH. We will stand in ease for the next 4 minutes while the members of the Task Force eat lunch.

[Recess.]

Chairman SMITH. Congressman Bartlett, thank you for your willingness to go ahead of time, and we will have Representative Markey join you when he gets here.

STATEMENT OF HON. ROSCOE G. BARTLETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. BARTLETT. Thank you very much. Mr. Chairman and members of the Social Security Task Force of the House Budget Committee, I want to thank you for the opportunity to testify before you this afternoon. I appreciate the opportunity to discuss H.R. 990, the Social Security Investment Fund Act of 1999, with the Task Force.

H.R. 990 was written to achieve a simple goal: putting the excess Social Security taxes to their highest and best use. We believe that the surplus taxes collected for Social Security should get a rate of return comparable to what a fund manager would get for a private retirement program. With that in mind, the Social Security Investment Fund Act was written to allow surplus payroll taxes to take advantage of the historically higher rates of return realized in the United States equities market. To accomplish this, our bill would authorize the managing trustee of the Social Security Trust Fund to transfer specific portions of the trust fund surplus to an independent agency which will broadly invest in the United States equity market.

The Federal Government has extensive experience with investing of this sort under the Thrift Savings Plan, the TSP. Because of the positive experience of the TSP, we chose to closely model the Social Security Investment Board after the Thrift Savings Board. I would like to point out that we are all members of the Thrift Savings Plan, and I cannot recall in my 7 years as a Member anyone taking to the well of the House to question the management of the Thrift Savings Plan. Not only can government manage broad-based stock investments, but it has been doing so for a number of years.

After the Social Security Investment Board receives the surplus Social Security revenue, the taxes will be invested in broad-based index funds. Index funds are passively managed funds which replicate the performance of the market as a whole, not individual stocks. The funds envisioned by H.R. 990 would be similar to the C-Fund in the Thrift Savings Plan. In all likelihood, the indices selected would be similar to the popular Standard and Poor 500 or the Willshire 5000. I believe it is important to point out that private sector professionals, such as those at the widely respected Standard and Poor's, will determine what companies are included in the Social Security Investment Fund by the criteria they establish to govern inclusion of stocks in their indices. Under our bill, there cannot be a room full of government bureaucrats picking and choosing what companies get included in an index.

I understand that there are some Members who have concerns about our bill. Many Members may be concerned that our bill will unduly involve the Federal Government in the affairs of national businesses. I had the same concern when I first started working on this bill. Mr. Markey and I went to great pains to include a number of provisions in this bill that would address these concerns.

As I mentioned earlier, the surpluses would be invested in broad-based private sector investment funds. This effectively prevents the fund managers from picking and choosing winners and losers. The companies that are included in the Social Security Investment Fund will be included because they are already a constituent company in a widely used private sector index.

Secondly, we prevent the manager of the fund from influencing corporate decision-making by requiring them to mirror vote their shares. This means that the managers are explicitly instructed to vote last and cast their votes in the same proportion as the votes were cast in the company as a whole. This will effectively eliminate any possibility of government managers having an effect on the selection of members of the corporate boards or on the formulation of corporate policy.

We have also included extensive reporting requirements so that the Congress will be able to closely monitor the management of the funds. Since the surplus would be invested in funds that track widely available private sector indices, it will be fairly simple to monitor whether or not the funds are tracking the indices or not. Since the members of the board will be regularly reporting to Congress, there will be ample opportunity to publicly address an inconsistency should it arise.

We also have included language in the bill which prohibits companies from being included or excluded from an index for social, political, or religious reasons. Although I may personally object to the policies of various companies in a fund, the only criteria that can be used for the inclusion or exclusion is whether or not they would otherwise be included in the index.

Finally, there have been some concerns that while our bill may be well crafted and left untouched would prevent the government from acting irresponsibly or imprudently, its provisions could be changed. I will be the first to concede that our bill can in no way prevent a future Congress from altering its provisions in breaking down the firewalls that we have constructed, but I have rarely heard Members retreat from passing good legislation because a future Congress could undo their good work. Should we abandon tax cuts because a future Congress may increase tax rates? Should we forsake Medicare reform because a presently unelected Congress would scuttle our changes? Of course not. What we have to do is pass prudent reform and remain vigilant in the future so the safeguards will not be undone.

Our bill represents a common-sense proposal that Members from both sides of the aisle can support. The bill will add at least 6 years to the life of the Social Security program without raising taxes or cutting benefits. It will get the Social Security surplus out of Washington and put it to work for Social Security beneficiaries. Most importantly, the bill will give the Congress the opportunity to craft a proposal that addresses the underlying demographic and unfunded liability problems that exist within the Social Security program.

Task force members, our bill is a modest proposal, but we believe the right proposal for the 106th Congress. I believe that comprehensive reform is not possible in this Congress. Early next year Presidential politics will take center stage. Considering the House has only passed three appropriations bills, we have a $788 billion tax bill pending, and it is nearly the 4th of July. I am unsure when we will have time for the national debate necessary to reach the consensus required for fundamental Social Security reform. With that in mind, I believe Congress should act while times are good and embrace the Bartlett-Markey bill and bide some time for Social Security while Congress works out a more comprehensive solution.

I thank the Task Force for its time and welcome any questions.

[The prepared statement of Mr. Bartlett follows:]

PREPARED STATEMENT OF HON. ROSCOE G. BARTLETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. Chairman and members of the Social Security Task Force of the House Budget Committee, I want to thank you for the opportunity to testify before you this afternoon. I appreciate the opportunity to discuss H.R. 990, the Social Security Investment Fund Act of 1999, with your Task Force.

H.R. 990 was written to achieve a simple goal; putting the excess Social Security taxes to their highest and best use. We believe that the surplus taxes collected for Social Security, should get a rate of return comparable to what a private sector fund manager would get for a private retirement program. With that in mind, the Social Security Investment Fund Act was written to allow "surplus" payroll taxes to take advantage of the historically higher rates of return realized in the United States equity market. Estimates are that investing a portion of the surplus in the equities market alone will add at least 6 years to the life of Social Security.

To realize this goal we establish an independent Federal agency which will be responsible for investing portions of the projected Social Security surplus in broad based private-sector index funds.

ADVANTAGES OF INVESTMENT IN AN "INDEX FUND"

At regular intervals, a portion of the surplus Social Security taxes that are not necessary to pay current beneficiaries will be transferred to the Social Security Investment Board to be invested for their benefit in broad-based stock index funds. "Index funds" are passively managed funds which replicate the performance of the market as a whole, not individual companies.

By investing in widely used indices the Social Security Investment Fund will be able to take advantage of the traditionally higher rates of return available in the equities market, effectively giving the taxpayer, "more bang for their buck."

The General Accounting Office (GAO) estimates that indexed investment in the stock market will have a long-term real rate of return of 7 percent, as opposed to the 2.5 percent real rate of return the Social Security Trust Fund currently receives on government securities. In addition to having a higher rate of return than the government securities, stocks are real assets that can be liquidated to pay beneficiaries, without having to resort to another government revenue stream. Indices are also a prudent choice, because they perform well when compared to actively managed private sector funds. The Standard and Poor's 500 (S&P 500), an index of the "large-cap" companies, out-performs over 75 percent of the actively managed mutual funds.

The funds envisioned by H.R. 990 would be similar to the C-Fund currently available in the TSP and administered by Wells Fargo. It is anticipated that the indices selected would be similar to the popular S&P 500 or the Willshire 5000. By selecting indices which only use value-neutral criteria, market-weighting in the case of the S&P 500, we will be vesting the market professionals, such as Standard and Poor's, with the responsibility for selecting what companies are included in the funds in the Social Security Investment Fund.

Finally by investing a portion of the Social Security Trust Fund in the American market, there will be tangible assets available for Social Security benefits when Social Security outlays surpass revenues in 2014.

ADMINISTRATION OF THE FUND AND THE SOCIAL SECURITY INVESTMENT BOARD AND EXECUTIVE DIRECTOR

The Social Security Investment Board will be composed of five members who will serve staggered 10 year terms. One of the members will be elected chairman. All of the members of the board will be required to have extensive private sector experience in the management of large investment portfolios. The members will be appointed by the President and require Senate ratification. The Speaker of the House and the Senate Majority Leader shall each recommend one member.

The Board develops policies to be carried out by the Executive Director. The Board is prohibited, however, from directing any investment in any specific stock. The Executive Director will be responsible for overseeing the investment of surplus Social Security revenue by qualified private-sector managers. The private sector managers will be chosen on a competitive basis consistent with Federal procurement policies. The managers will have to be presently engaged in the management of large portfolios in the private-sector. Because the surplus will be invested in existing indices, the managers will be competing only to provide the Board with administration of the funds for the lowest possible cost, not to sell the Board the "best" performing fund. It is anticipated that because there will be a small number of accounts to manage that the administrative costs of the Fund will be extremely low.

Safeguards to Prevent Political Manipulation

There have been a number of legitimate concerns raised about government directed investment. One of the most prominent concerns is that our bill will unduly involve the Federal Government in the affairs of national businesses. I had the same concern when I first started working on this bill. Mr. Markey and I went to great lengths to include a number of provisions in this bill that would address this concern.

As outlined earlier, the surpluses would be invested in broad-based private sector investment funds. This effectively prevents the fund managers from "picking and choosing" "winners and losers." The companies that are included in the Social Security Investment Fund will be included because they are already a constituent company in a widely used private sector index.

Secondly the bill prevents the members of the board, the Executive Director or the managers of the funds from influencing corporate decision making by requiring them to mirror-vote their shares. This means that the managers are explicitly instructed to vote last and cast their votes in the same proportion as the votes were cast in the company as a whole. This will effectively eliminate any possibility of the government managers having an effect on the selection of members of the corporate boards or on the formulation of corporate policy.

We have also included extensive reporting requirements so that Congress will be able to closely monitor the management of the funds. The Board and the Executive Director will be required to appear before the House Ways and Means Committee and the Senate Finance Committee semi-annually. The Board will also be required to file quarterly reports with Congress detailing the management of the fund. Additionally the Board will be subjected to an annual audit. These provision provide for a significant degree of transparency which is not required of many of the agencies Congress currently oversees.

In addition to the reporting requirements, the nature of the indices lends them to easy monitoring. Because the composition of the S&P 500 and the Willshire 5000 is widely known, and closely monitored in the markets, it would be difficult for the Board to inappropriately drop a company without eliciting the attention of Congress. Moreover, one would expect that if a company felt that it had been inappropriately excluded from an index, they would bring it to the attention of their Congressman. Because of the rigorous reporting and testimony requirements, there will be ample opportunity to publicly address an inconsistency should it arise.

Additionally, we have included language in the bill which explicitly prohibits companies from being included or excluded from an index for social, political or religious reasons. Although a Member or an interest group may object to the policies of various companies in an index and desire their exclusion, the only criteria that can be used for their inclusion or exclusion is whether or not they would otherwise be included in the index.

Lastly there have been some concerns, that these safeguards are insufficient because they can be changed by a future Congress. I will be the first to concede that our bill can in no way prevent a future Congress from altering its provisions and breaking down the firewalls that we have constructed. But I have rarely heard members retreat from passing good legislation because a future Congress could undue their good work. Should we abandon tax cuts because a future Congress may increase tax rates? Should we forsake Medicare reform, because a presently unelected Congress would scuttle our changes? Of course not. What we have to do, is pass prudent reform and remain vigilant in the future so the safeguards will not be undone.

Political Reality Makes Bartlett/Markey the Common-Sense Solution

Our bill represents a common-sense proposal that members from both sides of the isle can support. The bill will add at least 6 years to the life of the Social Security program without raising taxes or cutting benefits. It will get the Social Security Surplus out of Washington and put it to work for Social Security beneficiaries. Most importantly, the bill will give the Congress the opportunity to craft a proposal that addresses the underling demographic and unfunded liability problems that exist within the Social Security Program.

Task Force Members, our bill is a modest proposal, but we believe the right proposal for the 106th Congress. I believe that comprehensive reform is not possible this Congress. Early next year, Presidential politics will take center-stage. Considering the House has only passed three appropriations bills, we have a $788 Billion tax bill pending and it is nearly the forth of July, I am unsure when we will have time for the national debate necessary to reach the consensus required for fundamental Social Security Reform. With that in mind, I believe Congress should act while times are good and embrace the Bartlett/Markey bill and bide some time for Social Security while Congress works on a more comprehensive solution.

I thank the Task Force for its time and attention.

Chairman SMITH. Roscoe, it might be the plan that we move ahead with. I agree with you, it is important that we proceed with doing something to get some of the money out of town because the danger is you use it for something else, tax cuts or expanded spending. But your bill only extends the solvency for 6 years. Have you looked at or thought about what ultimately might be a way to keep it solvent forever or for at least 75 years?

Mr. BARTLETT. What this does it gives us 6 more years to have that debate and reach that conclusion. But the earlier we have the debate and reach the conclusion, the easier it will be to solve the problem.

Obviously there are only two things you can do. One is to increase revenues, and the other is to decrease expenses. I think that increasing revenues is unacceptable already. The FICA payroll tax is the largest tax on many working people's pay stub, so I don't think we can raise that percentage tax.

I don't think also that it is acceptable to reduce the benefits that current beneficiaries get. There are many of our senior citizens that live on the edge, and reducing these benefits would, I think, be unconscionable for them.

We might means test, and that is something we need to talk about. If, in fact, this is a trust fund, then we shouldn't means test. If it is an insurance fund, and you have invested your money in it, you ought to get back what you have put in, but after you have gotten back what you put in, I don't see any problems in mean testing beyond that.

I know that the President's Commission on Social Security Solvency has recommended that we simply increase the retirement age. It is now 67 for all born after 1960, I think. If we were to increase that to 70, most people believe that that would solve our Social Security solvency problem. And the truth is today at 70, we are healthier and will live longer than we would have at 65 when Social Security went into effect. As a matter of fact, when Social Security first went into effect, the average male did not live to be 65. The average female lived a bit longer. But today the average male will live longer after 70 than he would have lived after 65 when Social Security was put into effect. There are many seniors that do not want to be forced out of the job market at 65 or 67 in the future. They are very vital. They feel they have something to contribute, and so I do not find seniors adverse to increasing the retirement age to 70. It is my understanding that for the long haul this would solve the problem, but for the short term, we think that our bill, which I think addresses all of the concerns that Alan Greenspan had.

The government managers cannot pick and choose stocks. They can't even vote the stocks. They are mirror voting the stocks, and all we are doing is using the same prescription we have in the Thrift Savings Plan, which has been in operation for a number of years. We all are a part of this, and nobody complains about it. The amount of money that our plan would invest in the market is less than the amount of money that State and local retirement plans invest in the market, so it is not a really large share of the market.

Chairman SMITH. How long does your proposal extend the cash flow, positive cash flow, of Social Security? In other words, does it go beyond 2013 in terms of cash flow?

Mr. BARTLETT. CBO said it extended it 6 years.

Chairman SMITH. Six years would be the total solvency, assuming that all of the trust fund is paid back, so it takes it to 2039, as I understand it, but in terms of cash flow, right now there is going to be less taxes coming in than would accommodate payments by the year 2013, I think is the current date. Does your bill extend that?

Mr. BARTLETT. Six years on the front end means 6 years on the back end. It is my understanding it extended it from 2013 to 2019. Of course, all of this depends on your assumptions as to what the economy is going to do, but extended the date when the income and the expenses were going to be equal for 6 years, which gives us 6 more years to solve the problem.

Chairman SMITH. Has anybody calculated the administrative cost?

Mr. BARTLETT. The administrative cost should be very small. They are the same as administrative costs in the Thrift Savings Plan, and this, of course, was a part of the computations that CBO did. The Thrift Savings Plan had to be subtracted from the total increased revenues to reach the 6 years. I do not know what the percentage of the administrative costs are, but they are very, very much less than if you had an individual account and you were paying an individual fund manager to manage it for you.

Another good thing about our bill is that this would provide a mechanism so that when we move it—and I hope we do move to individual savings account—that when we move to individual savings account, that there will already be there a mechanism with very low administrative cost that you could choose to buy into, like now when you have the Thrift Savings Plan, you don't do that on your own. You are a participant with a large number of other people, so the administrative costs are very low. If you do an equivalent thing on your own, the administrative cost would be relatively very high.

Chairman SMITH. Currently thrift savings is working under two basis points, I believe.

Mr. Bentsen.

Mr. BENTSEN. No questions.

Chairman SMITH. Mr. Herger.

Mr. HERGER. I have no questions.

Chairman SMITH. Roscoe, I don't believe we have any more questions. Any final comments? And we can still allow Mr. Markey when he comes to give his testimony.

Mr. BARTLETT. Just a word about how we got here. We had prepared a bill, and when Mr. Markey's staff saw the bill, they called and asked us if we would like to participate with them. Mr. Markey is pretty much on the left of the political spectrum, I am pretty much on the right of the political spectrum, and I thought it was interesting that two people from the two ends of the political spectrum had similar notions as to how we might craft a bill that would meet some of the challenges that we have in Social Security.

We worked very hard. Mr. Pomeroy was a part of that, who previously was a State manager of this kind of fund, and he worked with us in crafting a bill that we thought met all of the objections that people might have and the objective of extending Social Security solvency.

We start out, by the way, with investing only about 15 percent of the funds. As time goes on, more and more of the funds are invested until near the end. Essentially 100 percent of the surpluses are invested here. This was intentional so that we would have experience; if it wasn't going well at any time, the Congress could change that, and we have ample opportunities to monitor this through the reporting requirements of the bill. But initially it is only about 15 percent of the surplus that would be invested. You could increase that 6 years to more years, and I don't know how many more years if you started investing all of the funds immediately. We thought that that was a step that Congress would not be willing to take; that this little demonstration, if you will, of 15 percent was something that would be acceptable, and then it grows as we gain experience with it to ultimately be essentially all of the funds that would be invested.

As you know, this market yields about three times more than has traditionally been yielded by the non-negotiable U.S. Securities, which by law now is the only place that these funds can be invested. The average investor, if he were retiring today, had invested his funds in the market, would have the equivalent of over $800,000 of investment. Social Security gives him about $180,000 of investment, the income from an investment, about a fourth of what it would be had he invested in the market. This is not accrued to the individual investor. It accrues to the fund, unlike a personal savings account where the increased income would accrue to the individual investor. This accrues to the Social Security Trust Fund, which extends it for the 6 years.

Thank you very much.

Chairman SMITH. Roscoe, thank you very much. Our compliments for your willingness to move ahead in this—down these tough roads.

Congressman DeFazio.

STATEMENT OF HON. PETER A. DeFAZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. DEFAZIO. Thank you, Mr. Chairman. Mr. Chairman, I have a prepared statement. I would enter it in the record and make some brief comments.

Chairman SMITH. It is entered into the record.

Mr. DEFAZIO. Thank you, Mr. Chairman.

Mr. Chairman, a bit in common with the previous gentleman, so I don't need to explain it, is I would take part of the surplus, 40 percent, and invest it, but invest it in an aggregate manner, but with the same protections as mentioned by the previous speaker.

In addition, what I adopted was an objective of 75-year solvency, no decrease in benefit, no increase in retirement age, and no impact on the general fund. And I did that through both the investment and through a lifting the cap on the ages upon which one pays payroll tax, and then since that provides more revenue than is needed for 75-year solvency, I provide a $4,000 exemption on FICA taxes. And as the previous gentleman said, more than 40 percent of workers in America pay more than FICA than they do in income tax. So my proposal would reduce taxes for 95 percent of wage-earners in America; that is, everyone who earns less than $76,600 per year. So 95 percent of the workers would come out ahead with a tax reduction. They would have no increase in—no decrease in benefits, no increase in age relative to full eligibility or partial eligibility with reductions.

I would also increase benefits for people over age 85, because the current system shows that people over age 85 are more likely to be in poverty when they are relying upon Social Security, and would provide for five child care dropout years; that is, parents should not be penalized if they stay home to raise their children.

So I meet the objectives of the trustees, 75-year solvency, and provide tax relief to 95 percent of working Americans.

Chairman SMITH. Thank you very much.

[The prepared statement of Mr. DeFazio follows:]

PREPARED STATEMENT OF HON. PETER A. DEFAZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Thank you, Mr. Chairman, Ms. Rivers and members of the Task Force for giving me the opportunity to testify today on my proposal to insure the future health of the Social Security program.

Social Security is one of the most popular and successful New Deal programs. It was created in 1935 and today provides essential retirement, survivors and disability benefits to 44 million Americans. Before Social Security was approved by Congress, more than one-half of America's elderly citizens lived in poverty.

Thanks to Social Security, fewer than 11 percent of today's seniors fall below the poverty line. Social Security provides more than half of the retirement income for two out of every three people over 65 years of age. Social Security benefits make up 90 percent or more of the income for about one out of three seniors.

It is important to understand that the Social Security Trust Fund is not bankrupt, nor will it be. According to the 1999 Social Security Trustees Report, Social Security is financially sound until at least 2034-35 years from now. Even if Congress does nothing to reform the program, Social Security will continue to provide 75 percent of current benefits for an additional 40 years—until the year 2073. With the relatively modest reforms that I am proposing, the Social Security system should be able to provide promised retirement benefits for many generations to come.

In fact, my proposal cuts taxes for 94 percent of working Americans, increases Social Security benefits for the most needy, and saves Social Security. My proposal amends the Social Security Act to restore 75 year solvency by:

- Providing a FICA payroll tax exemption for first $4000 of income, cutting taxes for 94 percent of all workers. This exemption would cut Social Security taxes by more than 11 percent for an individual earning $35,000 a year. Approximately 40 percent of American taxpayers pay more in FICA taxes than they pay in Federal income tax!
- Investing 40 percent of the future Social Security surplus in broadly indexed equity funds. Many state retirement plans already invest a portion of their surplus in the stock market.
- Making all earnings subject to payroll tax for both employer and employee beginning in 2000. Retain the cap for benefit calculations. This affects only those who earn more than $72,600 a year—less than 6 percent of wage earners.
- Increasing benefits at age 85 by 5 percent. Women over the age of 85 are more than twice as likely to live in poverty than men of the same age. There are more than twice as many women as men over the age of 85.

• Allowing up to 5 child-care drop-out years. Parents should not have reduced Social Security benefits because they chose to stay home to raise their children.

The Social Security program is the most successful government program ever undertaken. With these changes it can remain so. Thank you, Mr. Chairman. I would welcome questions from you or other members of the Committee.

MEMORANDUM

Date: June 8, 1999
To: Harry C. Ballantyne, Chief Actuary
From: Stephen C. Goss, Deputy Chief Actuary; Alice H. Wade, Actuary
Subject: Estimates of Long-Range OASDI Financial Effect of Proposal for Representative Peter DeFazio

INFORMATION

This memorandum provides long-range estimates of the effect on the financial status of the OASDI program of a proposed plan to change several provisions of the program. This analysis has been produced at the request of Aaron Deas of Representative DeFazio's staff. All estimates are based on the intermediate assumptions of the 1999 Trustees Report.

The comprehensive proposal is described in Table A, attached. Table A provides estimates of the change in the long-range OASDI actuarial balance that would result from the enactment of the total proposed package, as well as from each individual provision of the proposed package.

If all modifications are implemented, the resulting long-range actuarial balance for the 75-year period (1999–2073) is estimated to be +0.07 percent of taxable payroll. This is a change of +2.14 from the long-range actuarial balance under present law of −2.07 percent of taxable payroll. The combined OASDI Trust Fund would rise to a peak of 579 percent of annual cost for 2021, declining thereafter, and reaching a level of 217 percent of annual cost at the end of the long-range period.

Stephen C Goss
Alice H. Wade

TABLE A.—ESTIMATED LONG-RANGE OASDI FINANCIAL EFFECT OF REFORM PROPOSAL (REPRESENTATIVE DEFAZIO)

	Provision	Estimated change in long-range OASDI actuarial balance (percent of taxable payroll)
1	Invest a portion of the OASDI Trust Funds in stocks beginning in 2000, reaching 40 percent of assets in stocks for 2014 and later.	1.01
2	For earnings in years after 1999, change the OASDI contribution and benefit base to be a benefit base only. Subject all covered earnings to OASDI payroll taxes, but use the base to establish the maximum annual amount of earnings that is credited for the purpose of benefit computation.	2.02
3	Beginning in 2000, establish an exempt amount for a worker's annual taxable earnings. The exempt amount would be set at $4,000 in 2000, and would serve to exempt the first $4,000 of each worker's annual taxable earnings from the 6.2 percent employee's tax. For self-employed individuals, the provision would exempt the first $4,000 of self-employment income from one half of the 12.4 percent self-employed tax rate. The $4,000 would be included in determining benefit amounts. For years after 2000, the exempt amount would be indexed by growth in the SSA average wage index.	−1.03
4	In 2020, increase the level of benefits for all beneficiaries who are age 85 or older by 5 percent. This increase is phased in beginning in 2001. Benefit payments for beneficiaries meeting this age requirement would increase by 0.25 percent for 2001, 0.5 percent for 2002, etc., reaching 0.5 percent for 2020 and later.	−0.05
5a	Increase the benefit computation period by up to 5 additional years for new eligibles (by one additional year for new eligibles in each year 2005, 2007, 2009, 2011, 2013).	0.35
5b	Provide up to 5 child-care drop-out years. These years will be granted to a parent who has $0 earnings during the year and is providing care to his/her child under the age of 12 or to his/her disabled child. Drop-out years are phased in by one additional year for new eligibles in each year 2005, 2007, 2009, 2011, 2013. (This provision reflects interaction with provision 5a.)	−0.15

TABLE A.—ESTIMATED LONG-RANGE OASDI FINANCIAL EFFECT OF REFORM PROPOSAL (REPRESENTATIVE DEFAZIO)—Continued

	Provision	Estimated change in long-range OASDI actuarial balance (percent of taxable payroll)
	Total for Provisions 1 through 5 (including interaction among provisions)	2.14

Note: Based on the intermediate assumptions of the 1999 Trustees Report under present law, the long-range actuarial balance for the 75-year period (1999–2073) is −2.07 percent of taxable payroll.

Source: Social Security Administration, Office of the Chief Actuary, June 8, 1999.

Chairman SMITH. Alan Greenspan and Secretary Summers suggested to our Task Force that it is important to encourage additional savings. Do you see your plan as having an effect of encouraging additional savings and investment?

Mr. DEFAZIO. Well, since you would be providing much-needed tax relief to 95 percent of Americans if you made available an optional, you know, either—401(k)-type plan, as has been proposed by some, could be administered through Social Security, or you could enhance their capability of participating in IRAs or Roth IRAs on the other hand, that would certainly be money that would be available to them which is not now available.

Chairman SMITH. Peter, as I understand your proposal, it takes the cap off of the maximum amount that can be taxed under Social Security and has no increase in benefits over the current cap in terms of the calculation of benefits. Is that right? In other words, it adds another bend point of zero over $74,000.

Mr. DEFAZIO. That is correct. As indexed in the future, anticipating the indexation in the future of the capped amount of wages, the benefits would only rise with what is currently projected under—with the formulas in place today. So those monies, you know, would in effect go to relieve the burden of the entire fund.

The analogy goes to Medicare, of course, although there the benefits are uniform for all income levels. But we have lifted the cap on Medicare, so people are paying Medicare on their entire income, so it is a precedent.

Chairman SMITH. As you move Social Security—you can say it either way—in the direction of a welfare program or at least more progressive, do you think there is additional justification to have some of the funding come out of the general fund rather than the tax on wages that tends to be somewhat less progressive on lower income?

Mr. DEFAZIO. Well, I mean, that is a very interesting question. I mean, you could look at a progressive tax for Social Security. I did not go that far. What I thought, since people are accustomed to the existing flat tax, and 95 percent of Americans pay it on all their wages, you know, that the plan I proposed would mean for 95 percent of the people, you know, they would get the $4,000 exemption, some tax reduction, and for everybody over $76,600, they would be paying on all their income which they are now paying on the first $72,600. So it was less radical of a change in terms of people's thinking about Social Security. Certainly you could look at something closer to our income tax system where you have brackets at different income levels. That would be another way to go. I haven't seen anyone propose that yet.

Chairman SMITH. Any suggestions when we hit payback time of what is now estimated to be 2013 or 2014 when there is less Social Security taxes coming in that can accommodate benefits? In fact, your proposal probably would bring that back a year or so. I don't know——

Mr. DEFAZIO. I think a little more than that. We have the numbers at the office. I could certainly provide them to the committee, but what I would like to see is—which goes beyond the scope of this hearing—but for my mind, if the surplus does indeed arrive, as many pundits and economists and others are suggesting, rather than use it for general tax reductions or additional spending, I would use it to pay down the debt, which would enhance our capability to cash in those IOUs or bonds starting in 2015 or so. In fact, the President said yesterday, although I don't quite see the math, that current projections could show us at zero debt by 2017 or so; 2015, I believe he said.

Chairman SMITH. This would be zero public debt.

Mr. DEFAZIO. Right.

Chairman SMITH. The debt for what we would owe Social Security Trust Fund and other trust funds would continue.

Mr. DEFAZIO. Is that what he said? I was wondering about the math there, how it—with a trillion dollars additional surplus. But at any point if indeed—you know, we have to honor the IOUs, but if indeed, you know, we did get into some unexpected problems in the future, paying down our public debt would give us more flexibility to borrow if need be to meet hard and fast obligations to the Federal Treasury.

Chairman SMITH. That is an area that it is easy not to pay a great deal of attention. It is assumed in most of these proposals that what is owed to the trust fund is somehow automatically going to be paid back. Have you thought once we hit about 2022, 2025 that it is going to be substantial, and somehow we have got to increase borrowing or taxes or reduce other government expenditures to pay back what we owe the trust fund.

Mr. DEFAZIO. That has bothered me a long time. When I came to Congress and met Dorcas Hardy, then the Social Security Administrator, I said, what is going to happen when Social Security owns the entire debt of the United States, which at that point it was projected to be around 2005, and, of course, things have changed. She said, what do you mean? I said, wouldn't a future Congress be tempted to say, gee, why are we paying ourselves all this interest on this debt which we owe for this program? Let's cancel the debt and find some other way to finance it.

I have worried about that for a long time, which is why a long time ago I became interested in diverting some of the incoming Social Security Trust Fund money into other investments other than IOUs, which is why I have gone with the 40 percent proposal here as opposed to 15 of the President and I think 20 with Nadler and others, is to at least move 40 percent of that money that is coming in on an annual basis, and this year I believe it is—Social Security surplus is projected this year at 120, I believe.

Chairman SMITH. 127 maybe.

Mr. DEFAZIO. If 40 percent of that were diverted, we would have real assets and real income stream out there, and if we did that every year between now and 2015 or so, we would have a substantial income stream and assets even. If the stock market or the broadly diversified investments didn't do really well, would you still have something other than paper IOUs to pay the money?

Chairman SMITH. And Mr. Bentsen and I have talked about it. Now that we have proven that Congress is capable of wiping out some of that indebtedness to trust funds like we did in the Highway Trust Fund, we know what can happen.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. DeFazio, I will say this, though. Certainly you can have terms of an agreement where the debtor—the creditor and the debtor can cancel debt, and that doesn't necessarily undermine the value of the debt. But you raise an interesting point, if the only public—the only debt outstanding is nonpublic intergovernmental debt, and whether or not you try and get out from under it, I still think in a large-scale—a large-scale attempt to do that would have detrimental impact on future ability to raise debt in the capital markets. And I think you are right, Mr. DeFazio, that the President—I don't know that you are endorsing the President's proposal, but the idea of using some of the surplus to pay down the publicly held debt does put the Nation in a better fiscal position in the future to the extent you need to raise debt or raise capital in the debt markets. Your proposal, if I understand it, would invest 40 percent of the future cash flow stream from the Social Security payroll tax in the private markets——

Mr. DEFAZIO. Forty percent of that, which exceeds need for current benefits, yes.

Mr. BENTSEN. Of the surplus.

Mr. DEFAZIO. Right.

Mr. BENTSEN. In private markets in the same capacity as we do now with the Federal employees' thrift plan?

Mr. DEFAZIO. Actually very similar. It would be a broadly based index fund without voting rights. It would be very similar.

Mr. BENTSEN. And avoid any political tampering that might occur?

Mr. DEFAZIO. That is correct.

Mr. BENTSEN. But much more narrow than, say, States or localities invest their pension funds or the pension funds of teachers or State employees, where in some cases they invest in actual stocks, particular stocks, or capital projects or things like that.

Mr. DEFAZIO. Yeah, I did not go down that path. There is certainly an argument to be made. In fact, the PERS fund in my State, Public Employees Retirement System, had a rate of return to more than two times that of what Social Security gets on its fixed equities in a broadly diversified investment base which includes both individual equities, index equities and bonds and real property. So, I mean, there is certainly some case to be made for that. I just didn't—this was the least controversial route.

Mr. BENTSEN. Your construct is one that is the least political as well that the government is all of a sudden in the business of managing capitalism through stock ownership or something like that.

Mr. DEFAZIO. Right. Although in my State, again, they have—Fred Meyer, for instance, was one of their major equities because it was a Northwest-based corporation, and when it was bought out by a New York firm, even though they had substantial voting rights, you know, they did not exercise those to try and keep the headquarters in the Pacific Northwest. You know, the State has been—since they are required as fiduciaries to basically do things in the best interests of returns for the fund, we haven't found that kind of political manipulation because very infrequently does a political objective optimize returns. So in voting, they do have voting rights. They have voted as pretty much, you know, as people who—well, all the time as someone to optimize their income, not to optimize their political objectives.

Mr. BENTSEN. This wasn't where I was going, but you raise an interesting point that throughout the country, State and local governments invest in private markets like Fred Meyer, and they operate with the fiduciary responsibility as opposed to a political responsibility, and I think it is fair to say that we haven't seen a retreat to socialism as a result of this occurring.

Let me ask you this: Based upon your analysis or the analysis that has been done then, you invest 40 percent of the future Social Security surplus in private market index funds or whatever, and then you lift the cap on the payroll tax, and those two measures alone are sufficient to meet the needs of Social Security over the next 75 years?

Mr. DEFAZIO. No, they exceed the need.

Mr. BENTSEN. And furthermore, you are able to credit back $4,000—$4,000 tax credit for our payroll.

Mr. DEFAZIO. $4,000 of income would be exempt. So in fact, the total would be 2.0—would be 3.03 would be from those two assumptions. The lifting the cap is 2.02, and investing, the assumption used by the actuaries for 40 percent is 1.01, and the total need is 2.07. So we are considerably over and then——

Mr. BENTSEN. I am sorry, what were those again?

Mr. DEFAZIO. I can provide the table for the committee. They do it as a——

Mr. BENTSEN. So a little less than——

Mr. DEFAZIO.—percent of taxable payroll.

Mr. BENTSEN. A little bit less than half out of the return on investment and the other from the payroll.

Mr. DEFAZIO. Right. In fact, lifting the cap almost meets the total need. If you just lifted the cap, you would come very close to, within the margin of error, obviously, 75 years out, meeting the 75-year need if you made no other changes in the program.

Mr. BENTSEN. Finally, do you make any recommendation or proposal for what you do if investment of the 40 percent doesn't pan out; does that have any—can that affect your future cash flow needs in any given year, and to the extent that it does, does the government just underwrite any shortfall at that point in time?

Mr. DEFAZIO. Well, pretty conservative assumptions were used for rate of return and economic growth by the actuaries in projecting returns in a broadly based equity fund less than historic over the last 25 years. So certainly if we entered into another Great Depression, we are going to be in trouble with that portion of the fund's investments, but we would be in trouble with a whole bunch of other things. I haven't accommodated that, nor did I put in any special device.

You know, generally you just find that these things over time average out. That is the problem in the criticism of individual funds; if you happen to retire in a down year, or it may be in the middle of 5 down years, and the market was an individual fund, you are kind of out of luck in terms of annuitizing or whatever you have to do when you withdraw your money. But if you are part of a broad group which has a tail behind you and ahead of you, that all tends—you can maintain the benefit.

Mr. BENTSEN. If I might, back on the tax exemption or deduction, does that apply across the board?

Mr. DEFAZIO. That would be to the first $4,000 of income for all workers who work for wages and pay FICA taxes. That is correct. So essentially that would mean that with the current cap at $72,600, that means everybody who earns less than $76,600 would get a tax break, obviously skewed toward people at the bottom in terms of percentage.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman SMITH. During the apartheid controversy in the State of Michigan, we had a law that our pension program decisions could not be influenced by political decisions, with independent investors making the decision on how and where to invest the money. But on the apartheid controversy, we simply passed another law that was signed by the Governor saying regardless of all other provisions, it couldn't be invested in any company that was doing business with South Africa at the time. So I am still a little nervous of ways that we might insulate, protect those investments enough. Let me ask you——

Mr. DEFAZIO. Mr. Chairman, that is a very valid concern. As I recall, my State, the State legislature passed that, but then they were sued because the fiduciary responsibility was embedded in the Constitution for the trustees, and to tell the truth, I don't remember the resolution, but the other point I would make is that those sorts of restrictions on investment are now GATT-illegal, and since a majority of people here in Congress are great fans of GATT and the WTO, which I am not, we could not have those sorts of restrictions in the future under GATT and the WTO.

Chairman SMITH. One final question. Have you considered the danger—along this same line of discussion, have you considered the possibility that Congress and the President are going to look on investment revenues—the money coming in from capital investments, once we hit a crucial year of problems with cash flow, that governments might start looking at the returns on that capital investment to use for financing other government programs which would significantly reduce the benefits of long-term investment in terms of compound interest?

Mr. DEFAZIO. Well, the language that I have adopted would basically leave the—for instance, if any of the investments were to be terminated, those decisions are up to the board of trustees, and they are to manage only in the best interest of the fund. So, you know, you would have to somehow convince the board of trustees that it would be a better return for the fund to cash in some investments and divert that money to the Treasury that would replace it with IOUs at a lower rate of return, and so then the trustees would be immediately in violation of their responsibility.

Mr. SMITH. Thank you very much for your being here today and your willingness to move ahead for a solution to a tough problem.

The next witness to testify, I think, is Mr. Nadler, who is scheduled to be here in 3 minutes, and so we will stand at ease for 3 minutes and see if Mr. Nadler shows up.

[Recess.]

Mr. SMITH. Mr. Nadler has indicated that he is unable to be here, so the Budget Task Force on Social Security is adjourned.

[The prepared statement of Mr. Nadler follows:]

PREPARED STATEMENT OF HON. JERROLD NADLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you, Mr. Chairman, for your invitation to testify before this committee.

Earlier this year, I introduced H.R. 1043, legislation which would make Social Security solvent for at least 75 years without raising the retirement age, without cutting benefits, without shifting the risk onto individuals through private accounts funded by FICA taxes, and without raising tax rates.

This plan also would not adjust the CPI, would not force all new state and local government employees into Social Security, would not increase the benefit computation period above 35 years, and would not cut benefits by adjusting the bend points. This plan does not rely on general fund transfers beyond an initial 15-year period.

It has been scored by the Social Security Actuaries as completely eliminating the long-range OASDI actuarial deficit. In fact, it would improve the long-range OASDI actuarial balance by an estimated 2.55 percent of taxable payroll, replacing the actuarial deficit of 2.07 percent under present law with an positive actuarial balance of 0.48 percent of taxable payroll.

In addition, at the end of the 75-year period, Social Security would remain strong. In fact, the trust fund ratio would then be 793 percent. The current trust fund ratio is approximately 194 percent.

This plan would maintain Social Security as a guaranteed, life-long, cost-of-living-adjusted, defined benefit plan. That is the heart and soul of Social Security, and that is why I have fought so hard to preserve this vital program.

So, how does this legislation work?

Essentially, the bill would transfer 62 percent of the projected budget surplus to the Social Security Trust Fund for a period of 15 years, would provide for the investment of a portion of the funds in broad stock index funds, and would raise the wage cap above the current $72,600.

SURPLUS TRANSFER

The bill would implement the President's proposal to authorize the transfer of 62 percent of the projected budget surplus to the Social Security Trust Fund for a period of 15 years. It expresses this figure as a percent of taxable payroll, and is not dependent on actual budget surpluses to materialize. If the economy does better than predicted over the 15-year period, more funds would be allocated to Social Security. If the economy does worse, less funds would be transferred, and there would be correspondingly less pressure on other government spending.

THE INDEPENDENT SOCIAL SECURITY INVESTMENT OVERSIGHT BOARD

The bill would create the Independent Social Security Investment Oversight Board—members of which would have long, staggered terms—which would then hire several competing private managers to invest small portions of the Trust Fund in broad index funds which track the market based on a fixed formula. Some people incorrectly describe this as "government investment in the market". This is terribly misleading. There would be no picking and choosing of stocks by the President, Congress, or anyone else in government. The investments would follow a fixed formula and not the whims of some investment genius. No geniuses need apply under this plan.

The investment is completely private and fully insulated from political influence by several layers of protection. Federal employees currently invest in the market through the Thrift Savings Plan. I am not aware of anyone who has accused Congress of tampering with the market due to this type of collective investment. In fact, several of the plans that include individual accounts have similar restrictions on investments which would essentially require the same type of protections to be included in their plans. Individuals would be severely restricted in their investment decisions and in some cases only allowed to invest in broad index funds approved by the government.

Many state and local governments invest up to 60 percent of their assets in the stock market. This bill would authorize half of that amount and would prohibit investing more than 30 percent of total Trust Fund assets in the market. In order to extend the projected solvency of the Social Security system for 75 years, the bill invests a larger, but still prudent, amount of the Trust Funds in index funds than the President's proposal which extends the projected solvency for 56 years.

Keep in mind, under this legislation most of Social Security's funding will still come from payroll taxes and interest from government bonds. The Actuaries inform us that under current law in 2034, payroll taxes will still be sufficient to cover about 75 percent of benefit payments. The other 25 percent is from the Trust Fund. Only 30 percent of this Trust Fund is invested in the market. That means that only 7 1/2 percent is at any market risk at all. It has been estimated that if the market collapsed, and only held 50 percent of its current value, the ability of Social Security to pay benefits would only be reduced by about 2 percent. So the risk to the system, under this bill, is quite small.

The real difference between this approach and private accounts is that this approach is a lower cost, more efficient, and more prudent way of increasing the rate of return on Social Security assets. There are staggering administrative costs for setting up 150 million individual accounts and tracking them year by year for 40 years with allowances made for annual adjustments to each account. This is an incredible burden that is completely unnecessary and wasteful.

INCREASE, AND THEN INDEX, THE CAP ON TAXABLE WAGES

This legislation, starting in fiscal year 2000, also incrementally increases the cap on taxable wages above the current $72,600. Currently, approximately 86 percent of all wages are subject to FICA contributions. This has slipped in recent years from the historic 90 percent due to the dramatic rise in disparity of wages. The Social Security Actuaries inform us that 93 percent percent of wage earners earn less than the current cap, and, therefore, pay FICA taxes on all of their earnings. About 7 percent of wage earners do not pay FICA taxes on all of their income. My bill would require the wealthiest 7 percent to pay the same FICA tax rate on a slightly greater portion of their earnings. It would not eliminate the cap completely. To ensure fairness, these individuals' Social Security benefit levels would increase as well.

Keep in mind this plan makes the system solvent even under the Actuaries extremely pessimistic intermediate assumptions. Many of their predictions are questionable especially the fact that they predict economic growth to average 2.0 for the years 2000-2007, despite economic growth of 3.4 percent in 1996, 3.9 percent in 1997, and 3.9 percent in 1998. They then predict economic growth to take a significant downturn to average 1.4 from 2020-2040 and 1.3 percent in 2050-2070. They further predict that the economy will do even worse after that. To put these numbers in some perspective the economic growth rate was 4.6 percent from 1960-64, 5.4 percent in 1976, 7.0 percent in 1984. So H.R. 1043 restores solvency even in light of these extremely pessimistic predictions. If the Actuaries are wrong, and the economy does better than predicted, Social Security will be in even better shape.

The legislation that I have proposed, H.R. 1043, is also supported by Americans for Democratic Action, OWL (the Older Women's League), and the 2030 Center. A large national organization, a women's organization, and an organization primarily concerned with protecting the interests of young people.

[The prepared statement of Senators Moynihan and Kerrey follows:]

SOCIAL SECURITY SOLVENCY ACT OF 1999 (S.21), INTRODUCED ON JANUARY 19, 1999, BY SENATORS MOYNIHAN AND KERREY

BRIEF DESCRIPTION OF PROVISIONS

I. Reduce Payroll Taxes and Return to Pay-As-You-Go System with Voluntary Personal Savings Accounts

A. Reduce Payroll Taxes and Return to Pay-As-You-Go

The bill would return Social Security to a pay-as-you-go system. That is, payroll tax rates would be adjusted so that annual revenues from taxes closely match annual outlays. This makes possible an immediate payroll tax cut of approximately $800 billion over the next 10 years, with reduced rates remaining in place for the next 30 years. Payroll tax rates would be cut from 12.4 to 10.4 percent for the period 2002 to 2029, and the rate would not increase above 12.4 percent until 2035. Even in the out-years, the pay-as-you go rates under the plan will increase only slightly above the current rate of 12.4 percent. Based on estimates prepared last year the proposed rate schedule is:

2002–2029	10.4%
2030–2034	12.4%
2035–2049	12.9%
2050–2059	13.3%
2060 and thereafter	13.7%

To ensure continued solvency, the Board of Trustees of the Social Security Trust Funds would make recommendations for a new pay-as-you-go tax rate schedule if the Trust Funds fall out of close actuarial balance. The new tax rate schedule would be considered by Congress under fast track procedures.

B. Personal Savings Accounts

Beginning in 2002, the bill would permit voluntary personal savings accounts which workers could finance with the proceeds of the 2 percentage point cut in the payroll tax. Alternatively, a worker could simply take the employee share of the tax cut (one percent of wages) as an increase in take-home pay. In addition, KidSave accounts, of up to $3,500, would be opened for all children born in 1995 or later.

C. Increase in Amount of Wages Subject to Tax

Under current law, the Social Security payroll tax applies only to the first $72,600 of wages in 1999. At that level, about 85 percent of wages in covered employment are taxed. That percentage has been falling because wages of persons above the taxable maximum have been growing faster than wages of persons below it.

Historically, about 90 percent of wages have been subject to tax. Under the bill, the taxable maximum would be increased to $99,900 (thereby imposing the tax on about 87 percent of wages) by 2004. Thereafter, automatic changes in the base, tied to increases in average wages, would be resumed. (Under current law, the taxable maximum is projected to increase to $84,900 in 2004, with automatic changes also continuing thereafter.)

II. Indexation Provisions

A. Correct Cost of Living Adjustments by One Percentage Point

The bill includes a 1-percentage point correction in cost of living adjustments. The correction would apply to all indexed programs (outlays and revenues) except Supplemental Security Income. The Bureau of Labor Statistics has made some improvements in the Consumer Price Index, but most of these were already taken into account when the Boskin Commission appointed by the Senate Finance Committee reported in 1996 that the overstatement of the cost of living by the CPI was 1.1 percentage points.[1] Members of the Commission believe that the overstatement will average about 1 percentage point for the next several years. The proposed legislation would also establish a Cost of Living Board to determine on an annual basis if further refinements are necessary.

B. Adjustments in Monthly Benefits Related to Changes in Life Expectancy

Under current law, the so-called normal retirement age (NRA) is scheduled to gradually increase from age 65 to 67. In practice, the NRA is important as a bench-

[1] A number of improvements announced by the BLS after this legislation was first introduced in 1998 would lower the reported change in prices. The authors are considering what modifications, if any, should be made to the bill as a result of the BLS announcements. They are also discussing, with the Social Security actuaries, the effects of this change on the long-run projections made by the actuaries.

mark for determining the monthly benefit amount, but it does not reflect the actual age at which workers receive retirement benefits. More than 70 percent of workers begin collecting Social Security retirement benefits before they reach age 65, and more than 50 percent do so at age 62. Under the bill, workers can continue to receive benefits at age 62 and the provision in the 1983 Social Security amendments that increased the NRA to 67 is repealed. Instead, under this legislation, if life expectancy increases the level of monthly benefits payable at age 65 (or at the age at which the worker actually retires) decreases.

These changes in monthly benefits are a form of indexation that mirrors the projected gradual increase in life expectancy over a period of more than 100 years. For example, persons who retired in 1960 at age 65 had a life expectancy, at age 65, of 15 years and spent about 25 percent of their adult life in retirement. Persons retiring in 2060, at age 70, are projected to have a life expectancy at age 70 of more than 16 years, and thus would also spend about 25 percent of their adult life in retirement.

III. Program Simplification—Repeal of Earnings Test

The so-called earnings test would be eliminated for all beneficiaries age 62 and over, beginning in 2003. (Under current law, the test increases to $30,000 in 2002.) Under the earnings test benefits are withheld (reduced) for one million beneficiaries because wages are in excess of the earnings limit. This is an unnecessary administrative burden because beneficiaries eventually receive all of the benefits that are withheld. Indeed, Social Security Administration actuaries estimate that the long-run cost of repealing the earnings test is zero.

IV. Other Changes

All three factions of the 1994-96 Social Security Advisory Council supported some variation of the following common sense changes in the program.

A. Normal Taxation of Benefits

Social Security benefits would be taxed to the same extent private pensions are taxed. That is, Social Security benefits would be taxed to the extent that the worker's benefits exceed his or her contributions to the system (currently about 95 percent of benefits would be taxed). This provision would be phased-in over the 5 year period 2000-2004.

B. Coverage of Newly Hired State and Local Employees

Effective in 2002, Social Security coverage would be extended to newly hired employees in currently excluded State and local positions. Inclusion of State and local workers is sound public policy because most of the five million State and local employees (about a quarter of all State and local employees) not covered by Social Security in their government employment do receive Social Security benefits as a result of working at other jobs—part-time or otherwise—that are covered by Social Security. Relative to their contributions these workers receive generous benefits.

C. Increase in Length of Computation Period

The legislation would increase the length of the computation period from 35 to 38 years. Consistent with the increase in life expectancy and the increase in the retirement age we would expect workers to have more years with earnings. Computation of their benefits should be based on these additional years of earnings.

SUMMARY OF BUDGET EFFECTS

The legislation provides for long-run solvency of Social Security, with little or no effect on the budget surplus. In its latest (March, 1999) baseline, the Congressional Budget Office (CBO) projected that for the 5-year period FY 2000-2004, the cumulative surplus would be $953 billion, and $2.604 trillion for the 10-year period FY 2000-2009. Preliminary estimates, based on these budget projections, indicate that this legislation, while preserving Social Security, reduces payroll taxes by almost $800 billion, and only reduces the 10-year cumulative surplus by about $150 billion. In no year is there a budget deficit and, starting in 2007, the legislation increases the annual unified budget surplus.

[The prepared statement of Senator Gramm follows:]

PREPARED STATEMENT OF HON. PHIL GRAMM, A UNITED STATES SENATOR FROM THE STATE OF TEXAS

The attached summary provides a section-by-section analysis of the Social Security Preservation Act, an Investment-based Social Security reform plan authored by Senator Phil Gramm. According to estimates prepared by the Social Security Administration, "the plan would eliminate the long-range OASDI actuarial deficit, estimated at 2.07 percent of taxable payroll under present law. The OASDI trust fund would be substantial and rising at the end of the long-range 75-year period." In addition to providing permanent solvency, the plan guarantees each worker 100 percent of the benefits promised by the current system, plus a onus equal to percent of the benefits funded by their investments.

The Social Security Preservation Act allows each worker to set aside 3 percent of their 12.4 percent Social Security payroll tax, which will be owned by the worker and invested in stocks and bonds by a professional money manager in a "Social Security Savings Account for Employees" or "SAFE Account. The worker can choose from any privately-managed SAFE Account fund certified for safety and soundness by a Federal board.

Upon retirement, any worker can opt out of the investment-based system and receive I 00 percent of the Social Security benefits guaranteed to them under current law. However, it is expected that most workers will choose to remain in investment-based Social Security and will use the funds in their SAFE Account to purchase a "Savings Annuity For Eligible Retirees" or "SAFER Annuity." The SAFER Annuity will be guaranteed for life and supplemented by the Social Security system if it does not produce a retirement benefit at least equal to 100 percent of the benefits promised under the current system, plus a bonus equal to 20 percent of the payments funded by the SAFER Annuity.

Private companies offering SAFE Accounts and SAFER Annuities will charge all participants a single uniform investment fee, not to exceed 0.3 percent of assets. SAFER Annuities will provide workers of the same age the same monthly benefit relative to the size of their SAFE Account, regardless of sex, race, health status, etc.

Over the next 10 years, the Congressional Budget Office projects a Social Security surplus of about $1.78 trillion, while SAFE Accounts funded at 3 percent of OASDI wages would cost about $1.35 trillion, leaving $430 billion in Social Security surpluses. The Social Security Preservation Act uses these remaining surpluses to target additional investment for those aged 35-55 in the year 2000, allowing these workers to invest an extra 2 percent of their wages. These extra investments will begin to fund Social Security benefits at the height of the baby boom retirement, providing additional resources in the critical years of the transition. The extra 2 percent will not be counted in calculating the worker's 20 percent bonus, but will be used entirely to fund the benefits they receive from the existing Social Security system.

SEC. 1—SHORT TITLE AND TABLE OF CONTENTS

SEC. 2—FINDINGS

SEC. 3—ESTABLISHMENT OF INVESTMENT-BASED OPTION FOR SOCIAL SECURITY BENEFITS

Amends the Social Security Act to preserve all existing Social Security provisions (OASDI) in a new Part A and creates a new Part B providing an Investment-Based Social Security option for those workers who voluntarily choose to participate in the investment-based alternative.

SEC. 250 GUARANTEE OF PROMISED BENEFITS

Those opting into the Investment-Based system are guaranteed never to have a benefit less than that promised under the current system, plus a bonus of 20 percent of the benefits paid by their Part B investments.

SEC. 251 DEFINITIONS

SEC. 252 SOCIAL SECURITY SAVINGS ACCOUNTS FOR EMPLOYEES (SAFE ACCOUNTS)

Each current worker may choose to establish a Social Security Savings Account for Employees or SAFE Account. All individuals who will join the work force in 2000 or later will enter the investment-based system. The worker shall choose the investment fund to professionally manage his SAFE Account from among those investment funds qualified by high standards of safety and soundness, and may change funds once every year. The Account will be the property of the investing worker.

SEC. 253 SAFE INVESTMENT FUNDS

SAFE Accounts will be managed by qualified SAFE Investment Funds, which will be certified and regulated for safety and soundness by the new Social Security Investment Board. Under the parameters set by the Board, the Funds will invest the assets of the SAFE Accounts in stocks, bonds, bank deposits, insurance instruments, annuities and other earnings assets. The Funds will provide an annual report to each participant showing the dollar value of investments over the last quarter, the last year and the life of the SAFE Account. The report shall also project how much each worker will have at retirement if contributions and earnings continue at the same rate during the remainder of his or her working life. Each Fund shall accept all eligible workers requesting to join such Fund. The Fund shall charge all participants a single uniform investment fee as a percent of the investment, not to exceed 0.3 percent of assets.

SEC. 254 SOCIAL SECURITY INVESTMENT BOARD

Establishes a Social Security Investment Board which will set the general safety and soundness parameters of investments held as part of SAFE Accounts but will be prohibited from requiring or denying the purchase of any specific stock, or in any way dictating which individual investments are made. The Board will protect the safety and soundness of SAFE Investment Funds with the power to order compliance and, where appropriate, decertify and shut down any Fund found to be in violation of Board standards. The Board shall annually provide information on all qualified Funds to workers. The annual report shall include data on the rate of return achieved by each SAFE Investment Fund.

The Board will be comprised of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission and two outside experts with substantial experience in financial matters, who will be appointed by the President and confirmed by the Senate. One of the outside Members will be nominated and confirmed as Chairman.

SEC. 255 SAFE ACCOUNT CONTRIBUTIONS

Workers participating in the investment-based system will initially invest 3 percent of their wages into their individual SAFE Account. The remaining 9.4 percent of the current 12.4 percent paid in Social Security taxes would continue to be used to pay benefits under the current Social Security system. The 3 percent investment rate will automatically increase in the future as Investment-based Social Security becomes self-financing. In addition, workers age 35-55 in the year 2000 will invest an extra 2 percent of their wages to provide additional resources in the critical years of the transition. The extra 2 percent will not be counted in calculating the worker's 20 percent bonus, but will be used entirely to fund the benefits they receive from the existing Social Security system.

An entry on participating workers' paycheck stubs will show exactly how much money was invested in their SAFE Accounts for that pay period. The payment into the workers' designated account will be made directly from the Social Security Administration at least once a quarter. The Board is empowered to require that investments are made on a more timely basis if more frequent investment is deemed to be feasible.

SEC. 256 SOCIAL SECURITY SAVINGS ANNUITIES FOR ELIGIBLE RETIREES (SAFER ANNUITIES)

Upon retirement, a worker participating in investment-based Social Security will use the funds in his SAFE Account to purchase a Savings Annuity For Eligible Retirees or SAFER Annuity. Under the investment-based system, the SAFER Annuity will be guaranteed for life and supplemented by the Social Security system if it does not produce a retirement benefit at least equal to a) 100 percent of the benefits promised under the current system plus b) a bonus equal to 20 percent of the payments from the SAFER Annuity. This benefit will be fully protected against inflation. Each SAFER Annuity Fund must accept all eligible retirees requesting to join such Fund. SAFER Annuity Funds shall charge all participants a single uniform investment fee, not to exceed 0.3 percent, and shall provide each worker of a particular age the same monthly benefit relative to the size of their SAFE Account, regardless of sex, race, health status, etc.

EARLY RETIREMENT OPTION

Workers can retire at any age and draw their Investment-Based Social Security benefits once they have built up a SAFE Account large enough to fund a SAFER Annuity equal to at least 120 percent of the Social Security benefit promised at the early retirement age and fund any survivor, spousal or other benefits that might be triggered by their retirement.

Unrestricted Right to Use Remaining SAFE Account Assets

Workers who have built up enough funds in their SAFE Account to finance more than 120 percent of the benefits promised under Social Security and fund any other benefits their family might receive under the current Social Security system may use any remaining SAFE Account funds as they see fit.

Bequests

If a worker dies prior to retirement, the worker's SAFE Account, minus the present value of benefits promised to the surviving family members under the current Social Security system, will become part of the worker's estate.

SEC. 257 MONEY BACK GUARANTEE

Upon retirement, any worker may choose to opt out of the Investment-Based system and instead receive 100 percent of the benefits he would have received had he stayed in the current Social Security system. Those opting for this money back guarantee will receive monthly benefit checks directly from Social Security. Workers who opt upon retirement to return to the existing Social Security system will forfeit all their SAFE Account assets directly to the Social Security Administration to be deposited into the Social Security Trust Fund.

SEC. 258 GUARANTEE OF PROMISED BENEFITS

A worker whose SAFE Account is not sufficient to purchase a SAFER Annuity which will pay a monthly benefit equal to that promised under the current system plus a bonus of 20 percent of any payments from their SAFER Annuity will receive a supplemental payment from the Social Security Administration. Because this guarantee is based on the inflation-adjusted benefit a worker is promised under the current system, the guarantee fully covers the effects of inflation.

SEC. 259 INVESTMENT RATE INCREASES

Social Security Surplus Investment

In any year the Social Security Investment Board certifies that the annual Social Security surplus is greater than the amount needed to finance the 3 percent investment rate (and the temporary 2 percent additional investment to help cover the transition), the Board shall automatically increase the investment rate in increments of 1/10 of 1 percent, up to a maximum of 8 percent. If, in any year, the annual Social Security surplus is less than the amount needed to fund the 3 percent investment rate, the Social Security Commissioner shall redeem assets of the Trust Fund to ensure that benefits are fully paid and that the investment rate shall never drop below 3 percent.

Social Security Reserve

The Social Security Investment Board shall ensure that a suitable reserve is maintained in the OASDI Trust Funds.

SEC. 260 TAX TREATMENT OF INVESTMENT BASED SOCIAL SECURITY

SAFE Accounts and SAFER Annuities will build up tax-free until withdrawal. At retirement, payments from a SAFER Annuity up to 120 percent of benefits promised by the current system will be taxed in the same manner as Social Security benefits. Any additional payment, or any lump sum withdrawal, would be taxed as any annuity payment would be taxed under the Internal Revenue Code. The amount of SAFE Account contributions must be shown on a worker's W-2 as well as the worker's payroll receipt.

SEC. 4—PAYROLL TAX REDUCTION RESULTING FROM INVESTMENT-BASED SOCIAL SECURITY

After the investment rate has risen to 8 percent and the necessary portion of the remaining payroll tax is dedicated to fully fund disability insurance, the payroll tax rate shall drop from 12.4 percent to 8 percent plus the rate required to fund disability insurance.

SEC. 5 FINANCING OF INVESTMENT-BASED SOCIAL SECURITY

RECAPTURE OF FEDERAL CORPORATE INCOME TAXES ARISING FROM SAFE ACCOUNT AND SAFER ANNUITY INVESTMENTS

The Secretary of Treasury, in consultation with the Social Security Investment Board, will annually estimate the amount of corporate income tax revenues that can be attributed to the contributions and accumulated capital buildup in the SAFE Accounts and SAFER Annuities. Within 3 months after the end of each fiscal year, the Secretary of Treasury shall transfer to the OASDI Trust Funds the amount of Federal corporate income taxes attributable to the assets held in SAFE Accounts or SAFER Annuities.

In calculating the recapture rate during 2000 and 2001, the Secretary of Treasury shall assume that 80 percent of the total SAFE Account and SAFER Annuity assets are net additions to national investment, that 10 percent of that amount will be invested abroad and not subject to Federal taxes, and that 5 percent will be invested domestically but outside the corporate sector. Thus 68.4 percent of the profits from SAFE Account and SAFER Annuity assets shall be assumed to be net additions to taxable corporate income, resulting in an effective tax rate of 23.9 percent which will be credited to Social Security.

DEDICATION OF PART B SAVINGS TO SOCIAL SECURITY TRUST FUND

Any other savings resulting from Investment-Based Social Security that flow to the Federal Government, including increased revenues resulting from Federal taxation of SAFER Annuity bonuses and excess SAFE Account distributions, shall be credited to the OASDI Trust Funds.

DEDICATION OF BUDGET SURPLUS TO SAVING SOCIAL SECURITY

Each quarter beginning in the year 2000, the Secretary of Treasury shall reimburse the OASDI Trust Funds from the unified budget surplus an amount equal to the actual investments made in SAFE Accounts in that quarter. This reimbursement will be permanently reduced in any year that a reduction can be made without creating a future cash shortfall in OASDI, until the reimbursement is eventually eliminated. To ensure that these budget surpluses materialize, the discretionary spending caps in place under current law are extended through 2009.

[Whereupon, at 1:48 p.m., the Task Force was adjourned.]

The Cost of Transitioning to Solvency

TUESDAY, JULY 13, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON SOCIAL SECURITY,
Washington, DC.

The Task Force met, pursuant to call, at 12:10 p.m. in room 210, Cannon House Office Building, Hon. Nick Smith [chairman of the Task Force] presiding.

Chairman SMITH. The Social Security Task Force of the Budget Committee will come to order today for the purpose of hearing witnesses testifying on the cost of transitioning to solvency.

Today will be the last official meeting of this Task Force unless it is renewed. We have held 14 different meetings. I hope that we can come to some common bipartisan agreement on some findings in terms of outlining our goals on how we might proceed with solving Social Security, such as the finding that time is not on our side, and the longer we put the solutions off, the more drastic those solutions are going to have to be.

So without objection, we will reconvene this meeting at the call of the Chair probably this Thursday, and also, without objection, each individual Member may submit a statement by the 30th of this month that will be included in the final report and also, minority and majority views in that report. Hearing no objection, it is so ordered, and we will set the target date as of now for the 30th of this month to have those individual or minority/majority reports in.

Today's hearing focuses on transition costs. This topic is an essential element of the Task Force's mission to review the long-term budget ramifications of the various Social Security reform proposals and work toward a bipartisan solution of the impending insolvency of our Nation's retirement system.

We all know that there are only three ways to eliminate Social Security's $9 trillion debt in a closed system and estimated $4 trillion unfunded liability in an open system. Our choices are to raise taxes, to cut benefits or increase the rate of return that is earned on the taxes that are now coming in. The comprehensive reform plans that have been proposed use some or all of these three ways. Our witnesses have reviewed the various reform proposals under consideration and will tell us how each brings financial stability to Social Security.

We have an extraordinary opportunity, I think, to soften the impact of transition costs by using the Federal surplus to strengthen Social Security. Let us hope that we can work together and make this happen. Let us hope that there are some areas where we as a Task Force can have bipartisan agreement.

After witnesses have testified, we will open it for any individual Member that wants to make a comment today, and like we have already agreed to, those individual written comments and then majority/minority reports will be due by the 30th of this month.

And I would call on our ranking member, Lynn Rivers, for a statement.

Ms. RIVERS. No statement.

Chairman SMITH. Let me introduce our witnesses today. Dr. Rudolph Penner holds the Arjay and Frances Miller Chair in Public Policy at the Urban Institute. He directed the Congressional Budget Office from 1983 until 1987, highly respected by both Republicans and Democrats. He served as a senior government official at the Council of Economic Advisers and the Department of Housing and Urban Development. Dr. Penner has directed fiscal research programs at the Urban Institute and the American Enterprise Institute.

David John is a Senior Policy Analyst for Social Security at the Heritage Foundation, a 20-year veteran of Washington policy debates, and David has worked on Capitol Hill and in the private sector as well. We look forward to the testimony from Heritage.

And William Beach, of course, is Director of the Center for Data Analysis for the Heritage Foundation and has developed various econometric and computer models used by policy analysts. And we are very happy that within the last couple years the Heritage Foundation has taken on Social Security as a priority venture for them in terms to arrive at a solution.

And, Dr. Penner, we will start with you. All written testimony will be included in total in the record, and if you would keep your remarks to 5 or 8 minutes, we would appreciate it.

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Today's hearing focuses on transition costs. This topic is an essential element of the Task Force's mission to review the long-term budget ramifications of the various Social Security reform proposals and work toward bipartisan solution to the impending insolvency of our nation's retirement system.

We all know that there are only three ways to eliminate Social Security's $9 trillion unfunded liability and return the system to solvency: raise taxes, cut benefits, or increase the rate of return earned on the taxes workers pay. The comprehensive reform plans that have been proposed use some or all of these three ways. Our witnesses have reviewed the various reform proposals under consideration, and will tell us how each brings financial stability to Social Security.

We have an extraordinary opportunity to soften the impact of transition costs by using the Federal surplus to strengthen Social Security. Let's hope that we can work together to make this happen.

After witnesses have testified, Members will be invited to make closing statements. Finally, I want to propose Task Force findings review what we have learned during the past 4 months that we have been meeting.

STATEMENT OF RUDOLPH PENNER, ARJAY AND FRANCES MILLER CHAIR IN PUBLIC POLICY, THE URBAN INSTITUTE

Mr. PENNER. Well, Mr. Chairman, members of the Task Force, thank you for the opportunity to testify. As we all know, the current pay-as-you-go Social Security system is in trouble. Adverse demographics will force tax increases and benefit cuts in the future and the rate of return on tax payments will be far lower for future retirees than they have been in the past.

As a result, many believe that we should reduce our reliance on the current pay-as-you-go system and move toward a funded system in which real investments would provide income to fund pensions in the future. The rate of return on payments to pension accounts is then ultimately determined by the real return on investments rather than by demographic developments, and as a result, the expected rate of return will be much higher.

As I explain in my complete testimony, funding can be accomplished publicly or privately. Here I shall concentrate on private approaches, since I deem them to be highly preferable.

Funding involves a sacrifice. The money going into personal accounts could have been used for immediate consumption of goods and services. At the same time, people already retired or who are approaching retirement will not receive much benefit from funded pension accounts. They will have to be supported by the working population, and that will be an additional sacrifice.

The problems involved in moving toward funding are complicated by the fact that we start with a system in which the earmarked payroll tax is insufficient to fund future benefits and either benefit growth will have to be slowed or taxes raised to solve this problem. Solving this problem, therefore, also involves sacrifice.

The sacrifices involved in the financial problems of the current system will have to be faced whether or not we move toward a funded system. In policy discussions, the sacrifices involved in moving toward funding are often merged and muddled with the sacrifices involved in solving the system's financial problem. It is useful conceptually to keep the two problems distinct.

Both types of sacrifices can be distributed across generations and within generations in a multitude of ways. Both the transition problem and the actuarial problem can be mitigated by slowing the future growth of benefits. Here we face a difficult trade-off. The more quickly benefits are reduced, the smaller the necessary reduction. But quick benefit reductions are only possible if they affect those already retired or those near retirement. It is generally believed that this is undesirable because such people do not have much time to adjust their private saving or work efforts to change this in the rules, but if benefit cuts are phased in over a long period, they have to be much larger in the end.

My own feeling is that the sacrifice should be spread broadly and that the currently retired should not be spared some small cut. Tiny cuts now mean significantly less cutting in the future.

The sacrifice can be spread within generations in a variety of ways. Plans like the Smith plan and the Kolbe-Stenholm plan cut higher earners more than lower earners. Kolbe-Stenholm provides a new benefit equal to the poverty line for those who have worked 40 years.

The President's USA plan and Kolbe-Stenholm private accounts subsidize contributions to individual accounts by lower income earners to reduce the sacrifice that they have to bear. Such provisions show that reforms can be accomplished in a highly progressive manner if that is deemed desirable.

With all the talk of sacrifice, it should be emphasized that most plans do not impose much of a transition cost because they do not contain much transition. If we were talking about replacing the entire pay-as-you-go system with a Chilean-type reform, the transition costs would be quite enormous, but that is not politically plausible in the United States, and most plans from the political middle replace a relatively small portion of the current pay-as-you-go system.

Were it not for the actuarial problem, the total sacrifice of lost consumption would be less than 2 or 3 percent of total income immediately, and much less than that in the very long run.

Even the actuarial problem can be solved without huge sacrifice. It must be remembered that a considerable part of the actuarial problem comes from the fact that current promises involve providing average benefits that constantly rise faster than the inflation rate. Keeping the retired population at the current absolute living standard can help solve a considerable portion of the problem.

The current surplus can also be used to ease the immediate sacrifice because it means that we can fund contributions to individual accounts without reducing consumption below recent levels. True, we give up the potential of a tax cut or spending increases, but I think, as you said, Mr. Chairman, the existence of the surplus makes this all very, very much easier than it would be otherwise.

So it should not be as hard to solve the Social Security problem as it seems to be. I think people are reluctant to contemplate even small changes in the system because Social Security has been so popular and has worked so well in the past, but adverse demographics will keep it from working as well in the future, and therefore, it has to be changed.

Thank you very much, Mr. Chairman.

Chairman SMITH. Dr. Penner, thank you.

[The prepared statement of Mr. Penner follows:]

PREPARED STATEMENT OF RUDOLPH PENNER, ARJAY AND FRANCES MILLER CHAIR IN PUBLIC POLICY, THE URBAN INSTITUTE

The views expressed in this testimony are those of the author and do not necessarily reflect the views of the trustees and employees of The Urban Institute.

Mr. Chairman and members of the Task Force, thank you for the opportunity to testify. The current pay-as-you-go (PAYGO) Social Security system is in trouble. Revenue growth will slow because the rate of growth of the labor force is declining. Meanwhile, the number of beneficiaries will grow rapidly because of increases in expected life and the retirement of the baby boomers. The cost of benefits will outrun the revenues provided by the payroll tax, and either benefit growth will have to be reduced, payroll taxes raised, or general revenues used to finance the system. Regardless of the option chosen, the rate of return to taxes paid will be much lower for future retirees than for current and past retirees.

This has led many to support reduced reliance on the traditional PAYGO system and more reliance on a funded system in which contributions would be invested in a mixture of public and private securities, the return on which would be used to finance future pensions. The low rate of return created for the traditional system by adverse demographics would be replaced by a higher rate of return associated with investments in real capital. Both rates of return are associated with considerable risk, but given the current demographic outlook, the expected return on a funded system far exceeds that on a PAYGO system.

In theory, a funded system can be managed using either public or private accounts. Conceptually, the fundamental economic effects of the two approaches can be made to be identical. The dispute over which approach is preferable is therefore not a matter of economic theory. Instead, it involves different political forecasts as to how the two approaches would function in practice. Those of us who favor a private approach doubt that the government could resist dipping into the reserves of a public account in the long run in order to fund deficits emerging in the rest of government. We also worry that the government would use its investment policy to achieve political ends rather than investing in an optimum portfolio for future retirees.

But forgetting these problems for the moment, one can imagine diverting an amount of current tax revenue, say equal to 2 percent of payroll to a funding account that could be invested in stocks and bonds by either the government or private individuals. This approach is often called a "carve out" approach and essentially uses the current surplus to finance the move toward funding. The diversion of revenues can be from payroll taxes or any other taxes. The choice of an approach will have distributional and other consequences that are important, but the choice does not change the fundamental nature of the transition problem to be discussed at this hearing.

The important point is that the policy imposes a sacrifice. If the revenues were not diverted into a funded account, they could be used to finance a tax cut or some spending increase that would allow taxpayers to increase their consumption of goods and services immediately.

A different approach would either increase taxes to fund a public account or mandate that individuals invest a certain portion of their earnings in a personal retirement account. Assuming that individuals did not evade the mandate, consumption would have to be reduced immediately compared to levels enjoyed in the recent past.

The two approaches are meaningless unless they reduce consumption below what it would be otherwise. This is the same as saying that the reform must increase national saving, thus providing additional national wealth which can be used to finance the pensions of the future.

These approaches to increasing saving should be differentiated from recent "lock box" proposals that strive to increase national saving by running a unified budget surplus at least equal to the surplus in the Social Security trust fund. The lock box approach only increases national saving while the trust fund surpluses last, whereas true funding would go on indefinitely. Moreover, the amount of increased saving resulting from the lock box proposal is not directly related to future pension needs.

The language surrounding lock box proposals is more than a little confusing, but that does not mean that the goal of a lock box is a bad idea. If adhered to, it will increase national saving as long as trust fund surpluses continue. This is appropriate, since most economists agree that current American saving levels are woefully inadequate.

When people speak of a transition problem related to funding, they are referring to the fact that consumption must be forgone immediately to finance the funded account, but the funded accounts will be of no help to the currently retired and of little help to those soon to retire. These potential beneficiaries of the traditional system will have to be supported somehow by the working population and that will involve an additional sacrifice. The amount of the sacrifice can be reduced by reducing promised benefits, but it is politically unrealistic to assume that promises can be cut back radically.

The problem is intensified by the fact that the current earmarked payroll tax is inadequate to finance future promised benefits. Therefore, some benefit reductions or tax increases will be necessary, even if we do not move toward a funded system. Put another way, any sacrifice involved in moving toward a funded system will be on top of that involved in fixing what remains of the current PAYGO system.

In current policy discussions, the problems of fixing the current system are often merged and muddled with the problems involved in moving toward funding. The two problems are distinct and should be separated conceptually. But it is desirable to solve both simultaneously, and it is necessary to consider this twofold burden when analyzing reforms.

The sacrifices involved in solving both can be spread in different ways across different age cohorts in the population and within each cohort. Plans often strive to provide about the same retirement income as is promised by the current system. This can be done in two ways. Reductions in traditional benefits can be phased in slowly and designed to match the growth in income from individual accounts. The designer must make explicit assumptions about the rates of return to individual investments and this is a risky business. Of course, if such a reform were implemented, individuals could make their own assumptions about rates of return and if they preferred to assume lower returns on a safer portfolio, they could compensate by saving more than the mandated amount in order to replace traditional benefits. That is to say, they could choose to lower their risk by reducing immediate consumption by a larger amount. The second approach is to directly link the reduction in traditional benefits to the amount earned on individual accounts as in the Feldstein and Archer-Shaw plans. Then government bears a considerable portion, or all, of the risks of the investment and it is certainly not appropriate to refer to this as privatization. (Privatization is not a good word for any mandated highly regulated plan involving individual accounts.) Such guarantees make the approach more similar to public funding of benefits in that the general taxpayer bears some or all of the risk of the investment in private securities. In Congressman Smith's plan, the reduction in future benefits is linked to the amount contributed and not to the amount earned on the individual account. This approach leaves the general taxpayer with a lower contingent liability and is preferable in my view.

BENEFIT REDUCTIONS

To the extent that benefit reductions are used to ease the transition burden on future workers and to bring the existing system into actuarial balance, reformers face a difficult tradeoff. It is generally agreed that any benefit reductions should be phased in slowly, so that people have time to adjust to changes in the rules by altering their work effort and private saving. But if changes are phased in slowly, the ultimate reduction in benefits must be greater than if the changes are implemented immediately. This suggests that those currently retired should not be totally exempted from making sacrifices to help insure that future cohorts will have adequate retirement income. A very small current sacrifice can mean less significant cuts in traditional benefits for future retirees.

Many reforms cut taxes immediately to finance contributions to individual accounts while traditional benefit reductions are phased in slowly. An example of such a plan has been put forward by Representatives Kolbe and Stenholm. The effects of this class of plan on the unified budget balance are negative at first as the revenue loss exceeds the outlay savings from the benefit reductions. The negative impact grows for a time and in the Kolbe-Stenholm plan reaches a peak about 2012. But the outlay savings eventually catch up with the revenue loss and eventually exceed it, so that such plans ultimately improve the budget balance. Put another way, such plans first reduce the amount of debt that can be redeemed, all else equal, and depending on fiscal policy choices and economic developments between now and the time that their net cost reaches a peak, may require some net borrowing from the public.

Such plans probably would not be contemplated were it not for the current surplus. But the fact that such plans may temporarily result in a small deficit should not be considered a major problem. (The maximum negative effect of the Kolbe-Stenholm plan on the unified budget balance never exceeds 0.8 percent of the GDP.) To the extent that future Congresses decide to run deficits, it is equivalent to passing some of the costs of reforms to future generations. Those future generations will benefit from the reform in that they face a reduced burden associated with paying for traditional benefits. In other words, the explicit liability associated with government debt will replace some of the implicit liability associated with promised benefits. Unlike some, I do not believe that the two liabilities should be regarded as being equivalent on a dollar for dollar basis, but there is room for some tradeoff between the two types of liability. Alternatively, it may be decided 20 or 30 years from now that economic conditions do not warrant running a deficit and that taxes should be raised or spending cut. The issue again involves which age cohorts should bear the costs of reform and that need not be decided immediately for all future time.

There is a multitude of options for spreading the burden of benefit cuts within cohorts. Traditional benefits can be cut progressively by altering the benefit formula appropriately or by using means testing, although the latter runs the risk of destroying incentives for privately saving for retirement. The sacrifice imposed by mandated accounts can also be made progressive by subsidizing the contributions of low-income individuals as in the President's USA accounts and in the accounts established by the Kolbe-Stenholm plan.

TAX INCREASES

Tax increases can also be used to fund a public account or to reduce the actuarial imbalance in the current system. Whether one uses tax increases or benefit cuts to reform the system depends on what portion of the nation's resources one wants to convey to the retired population. Today, slightly more than half the noninterest civilian budget goes to the elderly. Those of us who emphasize benefit cuts as a solution rather than tax increases are concerned that elderly programs are already crowding out programs for children, defense, infrastructure and other things out of the budget, and unless benefits are reformed, the problem will intensify rapidly in the future.

If traditions are maintained and payroll taxes continue to be the main sources of income for the traditional system, revenue-increasing options are limited to rate or tax base increases. Roughly speaking, it takes a doubling of the tax base to produce revenues equivalent to a 1-percentage point increase in the tax rate. Base increases concentrate the pain of reform on the upper middle class and affluent two earner families while rate increases afflict all who have earnings. If the burden of a rate increase is examined relative to total income, the highest percentage burden tends to be on lower income families who do not have much income other than from earnings. However, the effects of a rate increase extend far up the income scale—far beyond the wage base, because affluent families often attain high incomes because they contain more than one worker. At the very bottom, the effects of a rate increase are mitigated somewhat on average, because the very poor are often at the bottom because they have no earnings.

THE SEVERITY OF THE TRANSITION PROBLEM

With all the above discussion of sacrifices and burdens, there is a danger of greatly exaggerating the pain involved in meaningful Social Security reform. Transition problems are very severe if a PAYGO system is entirely replaced with a funded system as in Chile, but such a radical reform does not seem politically plausible in the United States. Because the traditional American PAYGO system has been so popular, it is likely to continue to be a very large component of our public retirement system. A move toward funding is only feasible in my judgment if it is relatively small. Most plans for individual accounts from the political center convey the equivalent of only two or 3 percentage points of the current payroll tax into individual accounts. Were it not for the perceived need to simultaneously cure the actuarial imbalance in the traditional system, the pain of reform would be quite small. The immediate forgone consumption in many plans would initially be less than 2 percent of income and would be less than that in the very long run.

The existence of the current budget surplus provides a golden opportunity to further reduce the pain of partially funding the system. It allows a portion of revenues to be saved either publicly or privately without having to reduce consumption below current levels. It is true this approach sacrifices the opportunity for tax cuts or spending increases, but that is much easier than having to accept the reduction in consumption that would be necessary if a tax increase was necessary to fund a public account, or a mandated contribution to an individual account was imposed on top of the current tax burden.

Although the problems of the actuarial imbalance and of any move toward funding will have to be solved simultaneously, they should not be confused conceptually. Because the current system is not sustainable under current law, some sacrifice will be necessary even if we do not move toward funding. It is therefore illusory to compare reform plans to the current system as though current benefit and tax laws can be sustained forever. The Congressional Research Service (CRS) has done a good job analyzing different reforms under two scenarios—one in which benefits are lowered to payroll tax receipts and another in which taxes are raised to finance promised benefits. If adverse assumptions are made—retirement at age 65, bond rate of return on individual accounts, no retirement saving that is not mandated—monthly retirement income tends to be lower than that under current law in plans like Moynihan-Kerrey or H.R. 4256 for most of those retiring before the trust fund empties, but much higher after, if it is assumed that benefits are lowered to tax receipts. If taxes are raised to finance promised benefits, the burden on future taxpayers will be higher than under the reform plans.

The sacrifice will be even less if the move toward funding is successful in increasing saving and enhancing economic growth. The CRS study is inconsistent in this regard in that the projections of future retirement income implicitly assume that people truly increase their saving by the amount of any mandate, but it does not take account of any increase in incomes that might result from enhanced economic growth.

This is a tricky issue whether funding is done publicly or privately. It was noted previously that public funding will not work if surpluses in any retirement fund allow deficits to be larger in the rest of government. Mandates to save privately can also be evaded if people respond by reducing other retirement saving or by borrowing more. However, any plan cutting the growth of benefits provides a powerful inducement for people to save more privately in order to replace those benefits. Consequently, it is my judgment that a mandate combined with a benefit reduction would be very effective in increasing saving. Saving should also rise, even though individual accounts are voluntary and also in the case where no special provision has been made for private saving to offset benefit cuts. However, mandates may be useful in encouraging people to exercise the self-discipline that they should be exercising in any case when confronted by lower Social Security benefits than they originally expected.

To the degree that saving is increased as the result of Social Security reform, growth should be enhanced. This does little to reduce the proportionate economic burden imposed by the Social Security system, because faster growth means higher wages and higher wages mean higher benefits. However, more growth makes reform less painful, because it reduces any loss of consumption compared to past history. Indeed, it should be noted that today's system promises each successive cohort of retirees a higher real benefit. Simply, keeping traditional benefits constant in real terms would solve a significant portion of the financing problem without at all reducing the absolute living standard of average retirees.

CONCLUSIONS

It is necessary to contemplate two types of Social Security reform, both of which are highly desirable. First, we have to adjust to the fact that under current law payroll taxes are not sufficient to finance promised benefits in the long run. Second, it would be useful to fund part of the system, so that the rate of return to tax payments is dependent on the real return to capital rather than on demographic variables. Both types of reform will impose sacrifices in the sense that someone's consumption will have to be lowered below what it could be otherwise, either now or in the future. However, the total sacrifice is not large in size, because most politically feasible reforms fund only a small portion of the public retirement system and if we act quickly, the financing problem under current law is small relative to total income. Moreover, the sacrifice can be spread in an infinite number of ways among and within the generations. The neediest in society can be easily protected against any drop in absolute living standards.

Consequently, Social Security reform should not be as hard as it is. Part of the problem is due to a lack of understanding of the current system and of the implications of specific reform proposals. More important, Social Security is hard to reform because it has been so popular and has worked so well in the past. But it cannot work as well in the future because of adverse demographics. Leaving it the same is not a viable option in the long run.

Chairman SMITH. Mr. John and Mr. Beach, do you have a preference on who goes first? Mr. John.

STATEMENT OF DAVID C. JOHN, SENIOR POLICY ANALYST FOR SOCIAL SECURITY, HERITAGE FOUNDATION

Mr. JOHN. We appreciate the opportunity to appear before you today to discuss the cost of transitioning to a solvent Social Security system.

High transition costs will be a fact of life for Social Security regardless of whether the program is radically reformed or just left as it is. As a result, the transition costs of the various reform proposals should be measured against the costs associated with doing nothing at all.

We define the transition costs for Social Security retirement programs as the total amount of money that must come from sources other than Social Security payroll taxes at the current level.

The easiest way to measure this cost is to look at the annual cash flow deficit of the OASDI trust funds under both the existing program and the various proposals that have been made. We have used the cost estimates made by the SSA's Office of the Chief Actuary with only one change. While SSA measures these amounts in percentages of taxable payroll, we have translated them into constant 1999 dollars in order to make them more understandable.

Increased payroll taxes, whether by raising the wage cap or increasing the tax rate or other revenues that are used to fill the operating deficit, count as part of the transition costs under this definition. This is true regardless of whether or not the general fund revenues come from a budget surplus. In either case, they represent additional resources that are used to pay Social Security benefits.

Three quick examples for the year 2020 show how this definition applies to the existing system and the various reform plans. Looking at SSA's intermediate prediction for the existing program in 2020, the OASDI trust fund is estimated to take in $634 billion in taxes and pay out $737 billion in benefits. Even if this $104 billion operating deficit is covered by liquidating some of the assets in the OASDI trust fund, that money comes from sources other than the payroll tax and should be considered part of the transition cost.

This is not to imply that the special issue Treasury bonds held in the trust fund are worthless or will not be repaid on schedule. However, the Analytical Perspectives volume of President Clinton's fiscal year 2000 budget accurately characterized the assets in the trust fund when it said:

"These balances," I quote, "are available to finance future benefit payments only in a bookkeeping sense. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits, or other expenditures," end quote.

Looking at the Kolbe-Stenholm plan, in 2020, by comparison, after adjusting the traditional benefit, SSA found that $57 billion will be transferred from general revenues to cover the operating deficit. A further $27 billion will be brought in from the effect on the income tax collections of reestimating the CPI, Consumer Price Index, for a total transition cost of $84 billion in 2020.

The Archer-Shaw plan makes no change in the existing payroll tax rate or to the existing benefit structure. However, it funds individual accounts with an amount of general revenues equal to 2 percent of income and requires general revenue funds to pay a portion of Social Security benefits during its transition period. Thus, in 2020 the transition cost for Archer-Shaw includes both $98 billion for the amount that goes into the personal accounts and $72 billion that is used to pay some benefits for a total transition cost of $170 billion.

The source of the money for general revenue transfers to pay Social Security benefits is extremely important. In short, no matter where the money comes from, Congress will always face opportunity costs.

The phrase, "There is no free lunch," has never been truer than in this situation. To the extent that the money is borrowed, future generations will bear a significant interest cost that will be in addition to the base transition cost.

The other alternatives are to cut spending or raise payroll taxes. Future Congresses may face the choice between paying Social Security benefits or paying for education or defense programs.

It is easy to assume that this money can be repaid out of surpluses, but there is a catch to the recent good news on that front. Over the last 6 months, the White House's estimate of the cumulative 15-year budget surplus has gone up by $1.1 trillion. However, the beginning of an economic downturn, which is inevitable at some point, could cause a downward revision of an equal amount. It is a fallacy to assume that these surpluses are inevitable.

There is no easy solution to Social Security. No matter what, future taxpayers will bear a significant additional burden to pay the benefits of that time's retirees. The only question is when the annual deficits begin, how big they are and how long they last.

The benefits of individual accounts would take some time to develop. Even if a taxpayer is allowed to begin them tomorrow, the accounts will not grow large enough to offset any significant amount of the traditional benefits for a good 20 to 30 years.

If Congress does nothing, the annual cash flow deficits for Social Security begin in 2014. They reach $516 billion in 1999 dollars by 2070. It appears that the annual deficits continue and grow in size as long as they can be measured. On the other hand, most reform plans start to run overall deficits sooner, but they tend to be smaller over time, and in a few cases they actually end.

Plans that finance individual accounts with part of the existing Social Security taxes must begin to run deficits almost immediately, for obvious reasons. There is less money going to Social Security. While these plans adjust the traditional benefit that is financed solely from payroll taxes, these reductions only begin to reduce costs after the individual accounts have had a chance to grow for a number of years. This necessary delay in cost reduction causes these plans to run significant deficits that grow for about 30 years and then begin to steadily decline.

Of course, there is more to be considered in Social Security reform than just aggregate costs. The simple fact is that for millions of low- and moderate-income families Social Security is the only retirement plan that they have. Unfortunately, for most of them, today's Social Security is not a good investment. At a time when the S&P 500 has gone up 20.5 percent in the last 12 months, Social Security earns the equivalent of only about 1.3 percent.

The objective of Social Security reform must be more than just restoring the financial health of the system. It is time to allow every American family, no matter what their income level, to have the opportunity to fully participate in our economy. Social Security reform must also improve the retirement income of low- and moderate-income individuals.

The real question is how responsible this Congress and the one following wants to be to future generations. It can do nothing and place a significant burden on our children or grandchildren, or it can act responsibly and reduce that burden.

Chairman SMITH. Thank you.

[The prepared statement of Mr. John and Mr. Beach follows:]

PREPARED STATEMENT OF DAVID C. JOHN, SENIOR POLICY ANALYST FOR SOCIAL SECURITY, AND WILLIAM W. BEACH, DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

We appreciate the opportunity to appear before you today to discuss the costs of transitioning to a solvent Social Security system. At the outset, let me state that the views that are expressed in this testimony are our own, and should not be construed as representing any official position of the Heritage Foundation.

High transition costs will be a fact of life for Social Security regardless of whether the program is radically reformed or just left as it is. While some consider transition costs to apply only to proposals that would reform Social Security, this is not the case. Since the existing program will begin to run cash flow deficits in 2014, the transition costs of various reform proposals should be measured against the costs associated with doing nothing at all. In fact, it would probably be more accurate to talk about "preservation costs" instead of transition costs.

"Transition Costs" Defined

We define the transition costs for Social Security retirement program as the total amount of money that must come from sources other than Social Security payroll taxes at the current level and the small portion of the income tax on benefits paid to certain higher income retirees. Thus, increasing the payroll taxes would count as part of the transition costs as would any general revenue that is transferred to the program.

The easiest way to measure this cost is to look at the annual cash flow deficits of the Old-Age, Survivors and Disability Insurance (OASDI) trust funds under both the existing program and the various proposals that have been made. For this analysis, we have used estimates made by the Social Security Administration (SSA) Office of the Chief Actuary with only one change. While SSA measures these amounts in percentages of taxable payroll, we have translated them into constant 1999 dollars in order to make them more understandable.

When considering the various reform plans, we compared the operating deficits (if any) that would result after subtracting trust fund income (mainly payroll tax revenues) from trust fund costs (the aggregate benefits that would be paid under the reformed system). However, let me emphasize once again that our definition only considers payroll taxes at the current level. Increased payroll taxes, whether by raising the wage cap or increasing the tax rate or other revenues that are used to fill the operating deficit count as part of the transition cost. This is true regardless of whether or not the general fund revenues come from a budget surplus. In either case, they represent additional resources that are used to pay Social Security benefits.

This analysis is limited to measuring the effect of various policy options on Social Security revenue and outlays, and by extension on the government's budget. It does not measure changes in the retirement benefits received by individuals. For instance, both the existing system and the Archer-Shaw plan assume that benefits will be paid at levels called for under current law, while the Gramm plan assumes that the combination of traditional benefits and individual accounts will equal at least 120 percent of that amount. On the other hand, the Kasich plan assumes that retirement benefits will remain at the current level instead of growing in real terms as is called for under existing law. Kolbe-Stenholm, meanwhile, assumes that Social Security retirement benefits from traditional sources will gradually decline as the amount available from individual accounts grows. These effects on the individual can only be measured indirectly in a discussion of transition costs.

Applying This Definition to the Existing System and Various Reform Plans

Three quick examples show how this definition applies to the existing system and various reform plans. Looking at SSA's intermediate prediction for the existing program in 2020, the OASI trust fund is estimated to take in $634 billion in taxes and pay out $737 billion in benefits. Even if the $104 billion operating deficit is covered by liquidating some of the assets in the OASI trust fund, that money comes from sources other than the payroll tax, and should be considered part of the transition cost.

This is not to imply that the special issue Treasury bonds held in the trust fund are worthless or will not be repaid on schedule. However, the Analytical Perspectives volume of President Clinton's FY2000 budget accurately characterized the assets in this trust fund when it said:

"These balances are available to finance future benefit payments * * * only in a bookkeeping sense. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, *will have to be financed by raising taxes, borrowing from the public, or reducing benefits, or other expenditures.*" (P.337—Italics added for emphasis)

On the other hand, the Kolbe-Stenholm plan diverts an amount of the Social Security tax equal to 2 percent of income to individual accounts and adjusts the traditional benefits to reflect the gradual ability of individual accounts to pay some portion of Social Security benefits. In 2020, after making these adjustments, Kolbe-Stenholm assumes that $57 billion will be transferred from general revenues to cover the operating deficit. A further $27 billion will be brought in from the effect on income tax collections of re-estimating the Consumer Price Index (CPI), for a total of $84 billion.

The Archer-Shaw plan makes no changes to the existing payroll tax rate or to the existing benefit structure. However, it funds individual accounts with an amount of general revenues equal to 2 percent of income and requires general revenue funds to pay Social Security benefits. Thus, in 2020 the transition cost for Archer-Shaw includes both $98 billion for the personal accounts and $72 billion to pay benefits for a total of $170 billion.

WHERE DOES THE MONEY COME FROM?

The source of the money for general revenue transfers to pay Social Security benefits is extremely important. In short, no matter where the money comes from, Congress must always face opportunity costs. They range from foregoing expansion of a non-Social Security program in order to pay the interest on borrowed money to being forced to raise taxes to support Social Security outlays rather than spending those funds on urgent needs in education or defense. Depending on a variety of factors, there also could be an effect on the growth rate of the entire domestic economy.

The phrase "There is no free lunch" has never been truer than in this situation. To the extent that the money is borrowed, future generations will bear a significant interest cost that will be in addition to the base transition cost. If the Federal Government borrows a significant amount for Social Security, under some circumstances this could cause an increase in interest rates for the overall economy. This in turn could lower economic growth, thus reducing payroll tax collections below anticipated levels.

Congress also needs to consider the effects on the rest of the budget that stems from increased general revenue spending to meet Social Security's challenges. . It is easy to assume that this can be paid out of surpluses, but there is a catch to the recent good news on that front. Over the last 6 months, the White House's estimate of the cumulative 15-year budget surplus has gone up by $1.1 trillion. However, the beginning of an economic downturn, which is inevitable at some point, could cause a downward revision of an equal amount. It is a fallacy to assume that these surpluses are inevitable.

In that case, future Congresses may face the choice between tax increases and significant reductions in other programs. If there is no surplus, where will the $104 billion come from that will be required to redeem assets of the trust fund in 2020? Will the 115th Congress sitting in 2020 be forced to reduce spending for education, highways, defense, or other programs to pay Social Security benefits? When considering transition costs, it will be important to consider aggregate deficits, how long they will last, and how large the individual annual deficits are. To a very real degree, the actions of this Congress and the next one will limit the ability of future Congresses to meet national needs.

YOU CAN PAY ME NOW OR YOU CAN PAY ME LATER

As it will become clear from looking at both the forecast for the current system and various reform options, there is no easy solution to Social Security. No matter what, future taxpayers will bear a significant additional burden to pay the benefits of that time's retirees. The only question is when the annual deficits begin, how big they are, and how long they last.

The benefits of individual accounts would take some time to develop. Even if a taxpayer is allowed to begin them tomorrow, the accounts will not grow large enough to offset any significant amount of the traditional benefits for a good 20 to 30 years.

If a portion of the existing Social Security tax is diverted to individual accounts, there is a direct relationship between the amount that can go into an individual account, the size of the initial deficits, and how soon the deficits can end. Diverting part of the tax reduces Social Security's income and causes almost immediate deficits. On the other hand, the more that goes into the individual accounts, the faster they grow to a significant size and can replace much of the traditional benefit. However, since the early deficits can be so large, most reform plans initially limit individual accounts to an amount equal to 2 percent of income.

If Congress does nothing, annual cash flow deficits begin in 2014. They amount to about $21 billion in 2015, $252 billion in 2030, and reach $516 billion in 2070. It appears that the annual deficits continue and grow in size as long as they can be measured. On the other hand, most reform plans start to run overall deficits sooner, but they tend to be smaller over time, and in a few cases they eventually end.

As expected, plans such as Kolbe-Stenholm, Kasich and the Senate bipartisan plan that finance individual accounts with part of the existing Social Security taxes begin to run deficits almost immediately. While these plans adjust the traditional benefit that is financed solely from payroll taxes, these reductions only begin to reduce costs after the individual accounts have had a chance to grow for 20 to 30 years. This necessary delay in cost reduction causes these plans to run significant deficits that grow for about 30 years and then begin to steadily decline.

For instance, Kolbe-Stenholm reaches a maximum annual deficit of $133 billion in 2030, but by 2070, the deficit has declined to only $38 billion. In several years in between, there is actually a surplus. The Kasich plan also reaches a maximum deficit of $187 billion in 2030, but deficits essentially end after 2065. This pattern is also true for the Senate bipartisan plan, where deficits reach $130 billion in 2030, but end in 2065.

Because our definition includes all outside revenues other than the existing level of payroll taxes, this pattern is also true for the Archer-Shaw plan. Even though under Archer-Shaw, the Social Security trust fund does not begin annual cash flow deficits until 2014, the level of general revenues that are necessary to fund the add-on individual accounts causes an almost immediate aggregate deficit. Thus, while Social Security runs a surplus in 2000 of $69 billion, the $74 billion for general revenues that goes into the Archer-Shaw accounts causes a $5 billion aggregate deficit. This deficit climbs to $255 billion in 2030, before declining to $185 billion in 2070.

Thus, what this Congress does will have a major impact on the future. In 2000, this country could face a Social Security surplus if Congress does nothing. Passing Kolbe-Stenholm, Archer-Shaw, the Senate bipartisan plan, or Kasich will result in a deficit of about $5 billion.

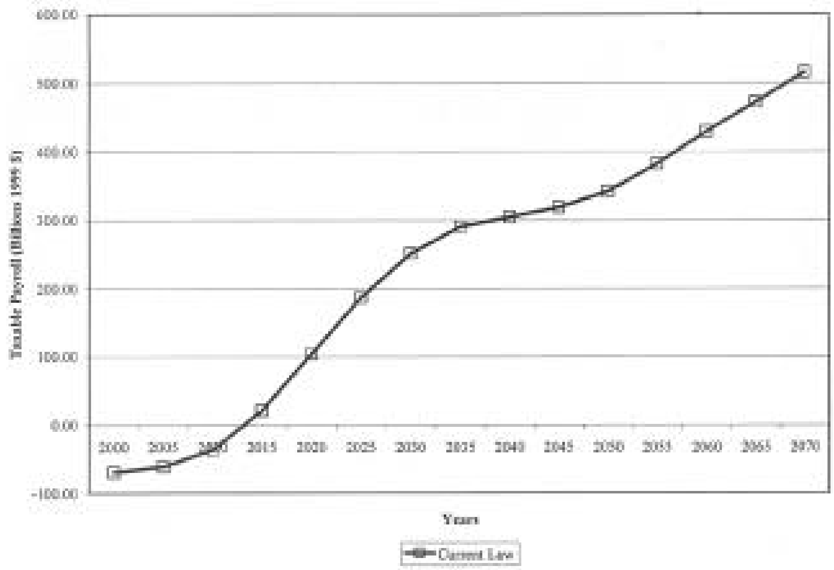
By the time a child born in 2000 reaches the age of 30 in 2030, the annual deficit will climb to $252 billion under the existing system. Under Kolbe-Stenholm, it would be $133 billion, while the Archer-Shaw deficit would be $255 billion. That same year, the Senate bipartisan plan would run a deficit of $130 billion, and the Kasich plan deficit would be $187 billion.

In 2070, the existing system will run a $516 billion deficit. For Kolbe-Stenholm, it will be $38 billion, for Archer-Shaw $185 billion. However, for both the Senate bipartisan plan and the Kasich plan, there will be no Social Security deficit.

Of course, there is more to be considered than just aggregate costs. The simple fact is that for millions of low and moderate-income families, Social Security is the only retirement plan that they have. Unfortunately, for most of them today's Social Security is not a good investment. At a time when the S&P 500 has gone up 20.5 percent in the last 12 months, Social Security "earns" the equivalent of only 1.3 percent.

The objective of Social Security reform must be more than just restoring the financial health of the system. It is time to allow every American family—no matter what their income level—to have the opportunity to fully participate in our economy. Social Security reform must also improve the retirement income for low and moderate-income workers.

The real question is how responsible this Congress and the one following want to be to future generations. It can do nothing and place a significant burden on our children and grandchildren, or it can act responsibly and reduce that burden. Your decision will have an even greater impact on our children's grandchildren. What kind of a legacy do we as a people want to leave to the future?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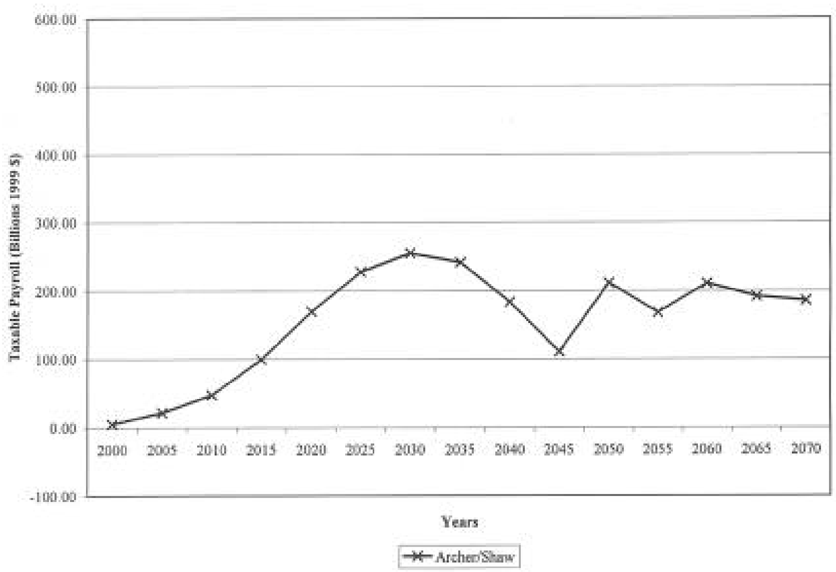
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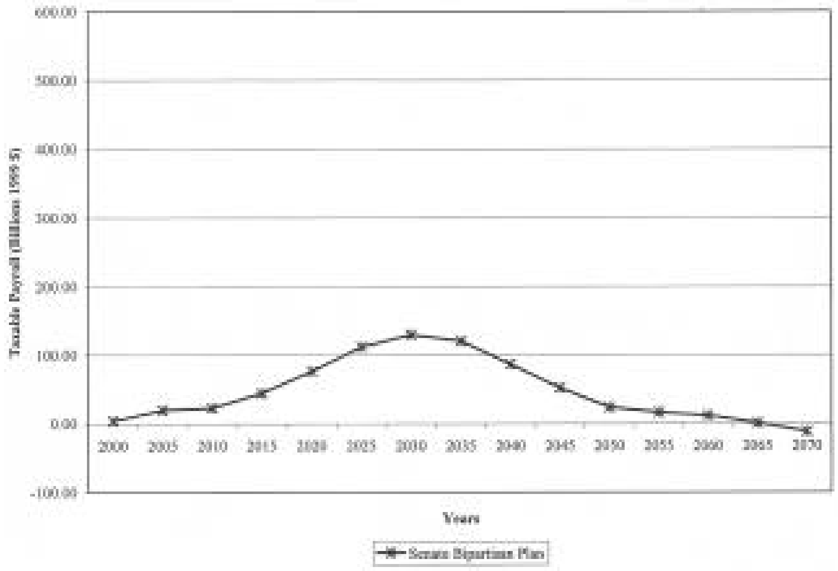

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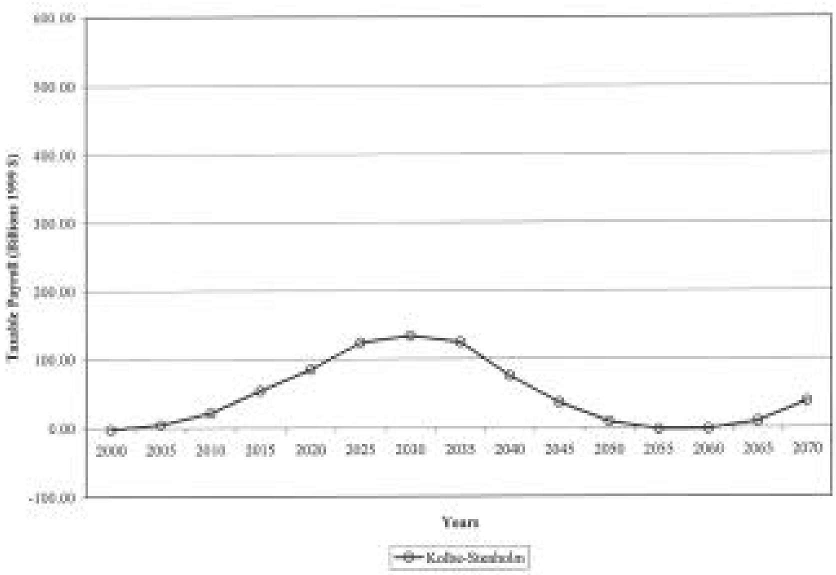

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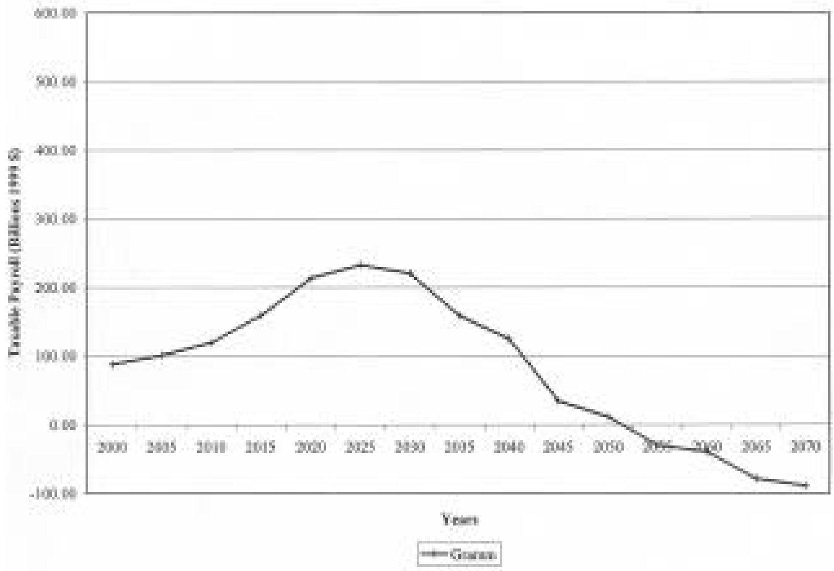

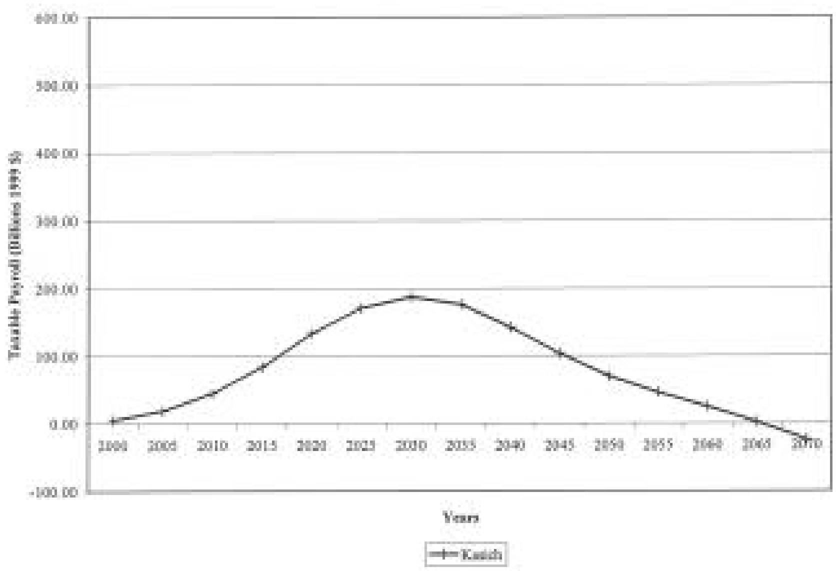

Chairman SMITH. Did you have a comment, Mr. Beach?

Mr. BEACH. Just a very quick comment, first, to explain why I am here. I am Robin to this man, Batman, today, so I don't have formal remarks.

Secondly, I would like to point out to the committee that this country has faced significant transition costs before, and there is in these hallowed halls, actually across the street, good history coming out of our own Revolution. As you may know from your history, this country faced a significant amount of debt which was going to significantly constrain the ability of the country to grow economically. Many of our creditors in Europe simply had given up on the United States when Alexander Hamilton funded the debt. That funding of the debt was done over a long period of time with long-term bonds—they didn't have income taxes at the time because it was not part of the Constitution—and it was successful.

Sometimes when we think about the challenges of funding our transition to a Social Security system that works from a trust fund standpoint and it works from a retirement standpoint, they seem like large obstacles, but we can keep in mind what many times we have done in this past.

Mr. Chairman, David and I have before you graphic material that shows various plans, just a selection of plans. I have brought with me a number of documents from Social Security to answer questions. All of these data are data from Steve Goss and his fine deputy actuaries over at the SSA.

Chairman SMITH. Dr. Penner, let me start with you. In an article published by Investors Business Daily last April, you stated: "By focusing the Nation's attention on solvency while ignoring the severe fiscal imbalances underlying both Social Security and Medicare the President does the nation a great disservice." That is somewhat aggressive. Do you still feel that way? And please elaborate.

Mr. PENNER. Yes, Mr. Chairman, I certainly still feel that way. I do feel that the President's proposal probably has a negative effect on the prospects for Social Security reform. By a bookkeeping entry, he makes it seem as though the problem is solved, but he did nothing to real benefits. He did nothing to the payroll tax, and I think it shows the problem of focusing on the solvency of the trust fund. That can be cured by the stroke of a pen, as he did it, but that in no way reduces the real economic burden of having to pay people benefits; and that burden, in my judgment, is much better measured by the ratio of those benefits to our total income or our gross domestic product. And that burden is going to start rising and rises quite rapidly after we get past the first decade of the next century. The total increase in that burden is roughly 2 percent of the GDP by 2030 or so. That is not a lot and wouldn't be much of a problem except that it is also combined with a much bigger rise in the Medicare burden caused by the same sort of demographics, plus the increase in the relative price of medical care.

So unless we focus on these real burdens, it seems to me that we miss the total problem. So while the President has made some proposals on Medicare, and I believe that those should be taken very seriously, his proposals on Social Security are an empty box as far as I am concerned.

Chairman SMITH. There seem to be several empty boxes from another perspective. Almost all of the Social Security proposals, there may be nine that have now been evaluated by the actuaries, assume that the Social Security trust fund indebtedness is going to somehow be paid back. That is technically a legal obligation, but the trust fund is not a financial asset until we find some way to pay it back. How should we be looking at plans to pay that back? And I will go across, with each of you making a comment on that.

Mr. PENNER. Well, I think that is exactly right, Mr. Chairman. The President has essentially just put a lot more debt into the trust fund. Some people refer to that as general revenue financing of Social Security, but I think that is a misnomer. It would be general revenue financing if he had said that in the future, maybe in 2020, he would like to see an increase of 10 percent in income taxes and 20 percent in the corporate tax in order to pay off that debt, but he has not given any indication of how that debt should be paid off in the future. So I would refer to it as general debt financing as opposed to general revenue financing.

Chairman SMITH. Mr. Beach.

Mr. BEACH. Yes, I agree with that. The source of all government revenues comes from the productivity of households, individual workers, and that productivity is taken from them in a sense through the tax system. Income taxes is a source for rolling over debts and other source. If we operate in a fashion to raise taxes on those households that are most covered by the Social Security system, we are doing a double disservice. Unless we reform Social Security to increase the savings in those households, we are doing a disservice. If we say we are going to balance on the basis of increased payroll taxes, increased aid to retirement and so forth, we are doing another disservice to those households, so we have to be very careful. But that repaying of existing debt must come, in some fashion or another, ultimately out of the tax sources.

Chairman SMITH. Mr. John.

Mr. JOHN. Well, as Bill said, the bottom line here is that we have our choice. We can raise taxes, we can reduce other government spending. There is not a whole lot else on the menu here. The biggest cost that is going to come up here is if we do nothing.

Chairman SMITH. Ms. Rivers.

Ms. RIVERS. Thank you, Mr. Chairman. I have several questions, but the first one I want to start with is, I know you have got your materials from the Heritage Foundation that you gave to us today. Would you be amenable to having the actuaries from Social Security take a look at them and put their comments in the record with yours?

Mr. BEACH. By all means, Congresswoman. The materials that we have today, in fact, are all taken from, except our comments, of course, from Social Security. So we would be more than happy to supply your staff with an exact duplicate of the materials I have in front of me.

Ms. RIVERS. Wonderful. A lot of the proposals that I have heard rely on either the on-budget surplus or the Social Security surplus as a source of funds for transition; and I have a couple questions about that. The first is, if you use any portion of the Social Security surplus, don't you exacerbate the problem that we were just discussing, which is the 2012, or I guess it is 2013 problem now, where we have to draw down on the trust fund; and then in 2034, you have got a gap between income and outgoing. So doesn't any proposal to use trust funds today, to plan transition to another program, intensify the existing liability of the existing program or make it worse?

Mr. PENNER. I think that if you want to retain the traditional characteristics of the Social Security system, that is to say, have the benefits largely funded by the earmarked payroll tax, then you are right that reducing the payroll tax to fund private accounts, as in the Kolbe-Stenholm plan, for example, means you have to make a sacrifice in the sense that you could have used those payroll taxes for something else in the first place. But also, you have a double burden. You have got to reduce future benefit growth sufficiently to fund the 2 percent diversion first of all, and then you also have to fund the 2 percent actuarial deficit in the system. So you must have substantial benefit cuts in the program.

If you are willing to go outside the system and use some general revenue financing, then obviously you will have to reduce benefits as much, but that leaves you with a bigger burden in the future, because benefits will be higher relative to our total income.

Ms. RIVERS. Do either of you want to speak to the issue of using the Social Security surplus?

Mr. BEACH. Yes, I would be happy to. Before you today are the drafts that I have already referred to, based on what the Office of the Chief Actuary has told us about the plans which are represented on the graphs. If I could answer your question by pointing to the baseline first, the baseline assumes that those Social Security surpluses remain available for current law use, and as we know from a couple of months ago when the trustees made their report on the Old-Age, Survivors and Disability Insurance trust fund, they predicted that by 2035, in that year, with the absence of assets now in the trust fund, that they would only be able to pay 71 percent of current law benefits; and that absent any other change by 2075, only 66 percent of current law benefits.

Now, as you notice from looking at the graph, the Office of the Chief Actuary has followed the plans in their detail and said, using the surplus in the way that each plan uses it and making the appropriate changes to current law, then points to COLAs and so forth, that in point of fact each of those plans results in a better actuarial balance by the end of that period of time.

So I guess my answer is, if we use the surpluses occurring to those plans, the actuary——

Ms. RIVERS. But these plans don't all rely exclusively on Social Security revenues. Archer-Shaw looks for general revenue funds.

Mr. BEACH. Exactly right, and you will see in each of these plans in some cases a very large use of general revenue funds, in some cases a more prudent use of general revenue funds. They all require some kind of funding outside of the system.

Ms. RIVERS. The other question I have regarding surpluses is about the general funding surplus, which people are only beginning to understand is predicated on the idea that we are going to see real cuts in domestic discretionary spending, about a 20 percent cut in real spending. What happens to these plans if these surpluses don't materialize, if we agree to make changes today, like Wimpy, I will pay you for a hamburger on Tuesday if I can have it today, what happens; and what we have seen in the 5 years since the Republican revolution is that even a Republican majority is not willing to make these kinds of cuts in the budget.

Mr. PENNER. As I explained in my complete testimony, the typical plan of this type lowers the growth of benefits very slowly, and on the other side you have an abrupt fall in tax revenues because they are conveyed to individual accounts. So all such plans substantially reduce the surplus in the short run. That reduction in the surplus tends to grow with most of these plans over time. I think with Kolbe-Stenholm it reaches a peak about 2012 and then eventually the cut in benefits catches up, and ultimately the plan is beneficial to the unified budget surplus in the very long run.

Now, if, in fact, our projections are far too optimistic, these plans can cause actual deficits in the future. At that time the Congress should ask itself, is this deficit permissible or should we do something to prevent it? You don't have to decide that now. Some deficit may be considered permissible because that is just a way of conveying some of the transition cost to future generations. We are, after all, relieving future generations of the burden of paying as high benefits in the future as under current law.

So you might say it is a fair trade, but again, I don't think the Congress has to decide that at this moment. They can decide that depending on how the surplus and economic conditions evolve in the long run.

Mr. JOHN. If I understand your question correctly, what you are asking is, if these overall budget surpluses fail to appear, how does that affect these charts. The answer is that it doesn't really affect them at all because these charts show essentially a hole that has to be filled from some form of resources in order to pay Social Security benefits under these different scenarios. Now, if there is a budget surplus at that point, then some of that budget surplus can be used to fill the hole. If there is no budget surplus at that point, then essentially either taxes go up or we have got to make other spending cuts.

Ms. RIVERS. Have you heard many people put that as part of their proposal? I mean, has anybody said, we will use the budget surplus, but of course, if there is a problem with the budget surplus, we are going to raise your taxes or cut your benefits?

Mr. JOHN. I haven't heard it said explicitly, but the simple fact is that this is true regardless of whether Congress does nothing or whether it passes Kolbe-Stenholm or Mr. Smith's plan or any of the others.

Ms. RIVERS. Thank you, Mr. Chairman.

Chairman SMITH. Thank you.

Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

A couple of questions, gentlemen. First, in evaluating the cost of a transition, assuming we were to engage in one from the current system to one that is more prefunded through a system of savings accounts, would you evaluate—aside from the politics of it, but looking at the economics of it, would you suggest that there is an advantage to minimizing the present value of the transition costs, and that rather than looking at given years, year after year, of what that deficit may be—or as you put it, the hole that needs to be filled with other resources—that it is most useful to discount everything back to a present value and to compare apples to apples by having that tool available.

If so, then I guess my real question is, does it help to divert more money sooner from, say, the payroll tax into personal accounts to start the benefit from the greater returns of investing in real economic assets; and while that may create a greater shortfall in the earlier years, does that lead to a lower total transition cost?

Mr. BEACH. Yes. In my view, it does, and I think that that is standard operating procedure in the private sector when you are looking at large investments and payoffs down the line, to size the problem up, begin quickly and move forward; and I think that that would be a prudent move in this particular case for yet another reason. This is not the major transition cost this Congress is going to have to face and that—of course, that major transition cost will be Medicare. It is there. The insurance pool is adverse to big changes.

So Social Security, I think you need to look at all—give me a discount factor, and we will come back to this table with those calculations based on Social Security's own estimates, and you can size it up at that point. Begin that process now. I think the sooner you get it started, the better. The economy will certainly benefit.

The earlier question about the economy is highly relevant to your particular question. If the economy doesn't perform based on the intermediate assumptions of SSA, but in fact below that—and it would have to be a pretty poor economy to be below the intermediate assumption—then the problem worsens, and it worsens rapidly sooner rather than later.

If there is an economic benefit from reform that does rely upon personal saving accounts, it will be able to realize that as soon as we begin to see the benefit offsets for the first retirees, and that should be in about 20-years, and that would be a good thing to get started soon, yes.

Mr. PENNER. I would agree that it is very useful to look at the present value numbers on these things, but I would suggest that under usual circumstances the choices you have to make are more choices of political values as opposed to economics in that regard.

Assuming the deficit or the surplus that evolves is not really large relative to GDP, then you have a lot of choices, and the more you borrow to fund the hole that David talked about, the more you are passing this burden on to future generations. So it is really a question of intergenerational equity: How much do we do for those who aren't born yet and not voting yet, and how much of a burden do we leave them?

Mr. TOOMEY. Thank you. One other question on a different line. I am looking at the graphic presentation that you provided us with. A question comes to mind, in particular if I look at the way you have depicted the Archer-Shaw plan.

Am I correct in concluding from that graph that what you are suggesting is that the Archer-Shaw plan essentially locks in a permanent hole that has to be filled from sources outside of Social Security? What I see is a graph that goes up and then it iterates a bit but seems to sort of level off somewhere over $200 billion. So is that a permanent deficit in the Social Security system that that reform plan would create.

Mr. BEACH. That is what Social Security has in fact concluded. That line rises to about $200 billion a year and that is what you were pointing to. In about 2050, under the plan, you have a reduction in the payroll tax rate; so that difference is not being replaced except through general funding or through the debt instrument funding.

Mr. PENNER. There is a bit of a problem with the analysis here, and frankly, as an analyst, I am not sure how to solve it. But many of the analyses of these various plans for the purpose of computing people's future income assume that people really increase their saving by whatever is mandated, or sometimes by the amounts in voluntary accounts.

On the other hand, that increased saving is not allowed to affect the future growth of the economy and the future growth of income.

Now, there is a lot of uncertainty as to how you would do that, but there is this basic logical inconsistency in the way much of the analysis proceeds.

Mr. TOOMEY. Thank you very much.

Chairman SMITH. Representative Clayton.

Mrs. CLAYTON. I am just wondering, as we look at the transitional costs, should I assume that we could have some efficiencies as they relate to savings, but in the public policies some of the transitional costs could be amassed but yet would come up later on? Let me give you an example.

If indeed, as I understood the gentleman from the Urban Institute to say, in terms of our beneficiaries, if we change the structure of our benefits, to see—one way of changing that is to structure it in a way that we wouldn't cover the disability, we would have that from another source, but at the same time, it is conceivable not to structure a finance resource for that would translate into a cost for Medicare and/or Medicaid that would not be accounted for here.

In other words, there are some public purposes in society, whether you fund it out of the payroll tax roll or fund it out of another source, it is going to be funded one way or another.

And another one would be—I don't know if you said it, but I have heard others say it—one way to look at the benefit coverage is not to be so generous to widows and to dependent children, so we would restructure this in such a way that it wouldn't be as generous; but again, the transitional costs could conceivably not anticipate the full costs until a dependent became 18 years of age, or do very much like similar retirement funds.

Could you speak to that? Could either of you or all of you speak to all the public purposes which Social Security now is providing in the transitional costs, because regardless of which model we went to support, assuming we are going to either do something with the source of income or the structure, am I to assume that you have anticipated all of those public goods that we are doing in your transitional costs?

Mr. PENNER. Well, I was negligent, I guess, in writing my testimony. I implicitly assumed that the disability system would go on as it is defined in current law, but I must admit I did not explicitly say that in my testimony.

Mrs. CLAYTON. I misunderstood you then.

Mr. PENNER. But with regard to particular social problems afflicting retirees, certainly old widows are among the poorest members of society, and I think if we can solve the big-picture problem, there would be a good reason to look at the possibility of increasing the benefits of that subset of the population.

In the Kolbe-Stenholm plan that I was involved in developing, there is a special new benefit, a minimum benefit equal to the poverty line for people who have worked 40 years. The basic message I wanted to get at in my testimony is that you have a lot of choices in how you design the rate of reduction of benefits or how the payments to individual accounts are designed. The President's and Kolbe-Stenholm plans actually subsidize contributions to individual accounts. So if you perceive social problems out there, I think intellectually at least it is very easy to address them in a reform proposal. Politically it might be more difficult, but I think there is a potential solution to almost every problem.

Mrs. CLAYTON. I was just wondering whether your assumption was in the transitional costs or in the restructuring?

Mr. PENNER. In those remarks, I am combining the two problems we face, transition and the actuarial deficit.

Mr. BEACH. Right. The data displayed before you, Congresswoman, is for the combined trust funds, Old-Age and Survivors Insurance and Disability Insurance. So we are working with 12.4 percent of the payroll tax and these numbers represent the spending gap, the outgo gap between revenues and expenditures associated with both programs. So this would be a combined situation.

As you know from studying this problem, the Disability Insurance trust fund is forecasted to have negative cash flows sooner than the Old-Age and Survivors Insurance trust fund; and also contained in these numbers are estimates by the actuaries of what transfers will have to occur from Old-Age and Survivors Insurance to Disability Insurance in order for that particular fund to be paying out benefits when its assets are essentially zero. So that is all contained in here, as well as the preretirement survivors insurance program which is funded through the Old-Age and Survivors Insurance program.

I point out to you that many of these plans do have significant changes in benefits. One of the major common elements, not in all plans but in many, is to adopt the rebased CPI, which has you know through the Boskin Commission is saying, has argued CPI has been too high for too long, let us bring it down a point. That is part of Moynihan-Kerrey, the old bill. That is part of the Senate bipartisan plan, Kolbe-Stenholm.

In the Kasich plan, he in fact moves the balance-point calculations which are important for figuring what that income will be during retirement away from the average wage index, which is growing at about a 4.4 percent rate to the CPI All Workers Series, which is growing at a much lower rate, so he has an implicit growth rate reduction in benefits, and that is one of the ways he gets to his actuarial balance points.

In point of fact, personal retirement accounts, while they are important to these plans, are only one of many of the important details and they are making a transition to get away from a negative actuarial balance of minus 2.07 percent to something closer to the zero line that you see going across. So I believe that Social Security has captured all of the related Social Security programs in their analysis.

You have raise a fascinating point: What are the spillover effects from Social Security reform to the non-Social Security entitlement programs, which are part of the package of work that Congress and the Federal Government does with older Americans; and of course, a big one is Medicare. A less large one is Medicaid for those who have reached retirement survivor situations. Clearly, that has to be addressed in looking at the full ramifications of reform.

Chairman SMITH. I think we will have time for a second round. Mr. Herger.

Mr. HERGER. Thank you.

Mr. Beach and perhaps anyone else who would like to comment, regrettably it would seem that Congress many times only makes changes when it has to, when we are confronted with it immediately in front of us, as opposed to 15 years out, if you will.

Mr. Beach, if you would make a comment, what is the impact—you have already spoken on this somewhat, but maybe if you would care to comment a little bit more—what is the impact of choosing now versus over time, and should we put reforms in place now that prepare Social Security for projected cash flow deficits 15 years in the future or should we make incremental changes to the system over time as they are needed?

Mr. BEACH. Well, thank you very much for that question.

One thing I have learned over the last several years in working on the Social Security reform agenda in the debates is that this is very much a generational program. People who are working today may not be saving for their retirement because of their income status because Congress has said there will be a viable Social Security retirement program for you in 30 years. So their time horizon is their entire working life. If you are a—well, take my family that grew up around Newton, Kansas. We are all Lithuanian immigrants despite my name. He was a foreigner who came into the family.

We were not in a position, Congressman, to save for our retirement. We did, but we did it as a family, as a community. We had a long time horizon.

What I am suggesting to you is this, that because of the long time horizons that the covered workers have with respect to their retirement, you should do this now to single people, that, yes, you do need to supplement your retirement income; or, yes, you do need to put, when you are 25, aside 2 percent and let it grow and be prudent in your investment. That is a key.

Can you make incremental changes along the way? Of course you can and you will. There are certain things, though, that you need to signal now so that workers who are 25 years of age know that that is coming in 30 years or 40 years when they retire.

Again, back to my original comment, the sooner you do that, the better off your chances are of success. If we had made changes in 1983 of the type that are envisioned in these plans that we have before you, we would no doubt be holding a different kind of hearing today, and I think we have the evidence of other countries and the success with which they have been able to fund much of their retirement overhang as a guide here.

So I wish we had done that. I hope that you will be doing this very soon for that reason.

Mr. HERGER. I think that is a very good point. I believe that even when Social Security was originally set up it was never set up to be a complete, as I understand it, retirement.

Mr. BEACH. You are right.

Mr. HERGER. You have people who tend to look at it that way, and perhaps Congress has oversold this.

Mr. BEACH. In fact, Congressman, the original first administrator of the Social Security system said that it is only one of a three-legged stool, that you have private savings or personal savings, that is one leg. You have something from your place of work; I wish we all had that now, but that was the second leg. And the third leg was Social Security. And he also said, once Social Security crowds out either of the other two legs, it is important to look at Social Security because it is supplemental.

Now, we have grown Social Security since that time, and it is a very large tax on low- and moderate-income households, and it has got to work for them as a retirement program. That is part of the mission here, not just to save the trust fund but to save a retirement program for people that are totally dependent on it.

Mr. PENNER. I think Bill made a really important point, and that is, it is so much better if you can give people advance notice of a change in the rules. When the later normal retirement age was phased in in the 1983 reforms, no one was affected that was older than 45 at the time. It is too late now to give that kind of notice. If I am correct, Mr. Chairman, your plan doesn't affect anyone over 58, but that is older. We had the luxury before of being able to give more notice, but now you have to move more quickly. So next year is not too early to do something about the problem.

Mr. HERGER. Thank you.

Chairman SMITH. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Penner, your testimony, there are a new questions about it. I appreciate your comments on page 6 regarding the Feldstein and Archer-Shaw plans, which I read to say that privatization, those plans aren't just privatization because you call it that. It is just trying to privatize the system for the sake of calling it privatization, but otherwise it doesn't really do much.

Mr. PENNER. I didn't mean to imply it didn't do much. It is not done privately.

Mr. BENTSEN. It doesn't seem to accomplish what the stated goal is.

I do take issue, if I understood you correctly, that the President is just debt financing because the question of how future obligations would be paid will be determined at that point in time, whether it is paid through existing revenues or through further taxes; and what you are saying in your testimony—you talk about the various carve-out plans, and in one case you use the current surplus to finance the move toward funding which, in effect, would be debt financing, as well, I presume, because any use of an on-budget surplus has some effect of possibly debt financing in the long run.

But more importantly, you make a comment that says the choice of an approach will have distributional and other consequences that are important, but the choice does not change the fundamental nature of the transition problems to be discussed at this hearing.

I know we are talking about transitional, and I think you get into great detail or at least conceptual detail about how you would deal with that, but what I am interested in is the first part of that sentence. In going to a carve-out, can you, for the benefit of the members of the panel, tell us what is the trade-off, what are the distributional and other consequences that exist, forgetting about, you know, holding harmless those who are not affected by the transition, but the retiree of the future that is under a carve-out? Because I think that is an area where we have heard what the potential upside is; we haven't heard what the potential downside is. And there is skepticism among, I think, more Members than just Democrats, but I think there is some skepticism that were this to really happen and were this to really work, whose ox gets gored or does everybody come out ahead?

And I am skeptical because I don't think there are plans where everybody comes out ahead. That is sort of, you know, the "free lunch" theory. And so I would like, given your expertise and experience on this, I would like to hear what you have to say.

Mr. PENNER. Well, first of all, differentiating the President's plan from the plans that are mentioned explicitly in my testimony, all of the plans I mentioned do real things to benefits one way or the other. The President's plan does not.

With regard to the distributional implications of having a carve-out versus an add-on, much of one's analyses of these different plans depends on political as opposed to economic forecasts. But if you think that you are not affecting future tax and spending decisions by what you do, you will obviously retire less debt immediately with the carve-out than if you had some sort of add-on plan. So, from a distributional point of view, you could say if that was the end of the analysis, the carve-out puts more of the burden and sacrifice on future generations, than would an add-on tax, say, to finance a funded account.

Mr. BENTSEN. Or not even an add-on, the chairman's indulgence, but just current law, trying to maintain a current benefit structure. Because you also say in your testimony, you talk about the reform and actuarial balance are not necessarily the same thing. So assuming you figure out a way to address actuarial balance, absent reform, and it may not be possible, but absent a change in the overall structure, what is the distributional effect of that?

Mr. PENNER. Well, just to finish my other point on carve outs first, I think what seems so appealing about them right now is political. I think it is a lot easier to have a reform that lets consumption go on at recently experienced levels as opposed to having a tax increase which actually makes people lower their living standard.

So that is why the surplus presents a golden opportunity but, of course, the lower the surplus, the more burden you are passing onto the future.

Can you move to more funding and reform the system without changing the benefit structure at all? It is theoretically possible, but then you get to a question of values. Already more than half of the non-interest, non-defense budget of the United States goes to people over 65. So the question really is how much of the Nation's resources do you want to continue to convey to those people as opposed to conveying them to children and defense and highways and all sorts of other things.

If you don't reform the structure, the proportion of the Federal budget going to the elderly is just going to grow and grow and grow. But deciding the proper portion is a value judgment. Do you really want to spend that much resources supporting people in longer and longer retirements, many of those people being very affluent people? So that is the value judgment you have to make. Sure you can do it without reforming benefits, but it means a big burden on the taxpayer in the future.

Chairman SMITH. The gentleman's time has expired. Mr. Collins.

Mr. COLLINS. Mr. Greenspan testified before the Ways and Means Committee several months ago that in order to address the Social Security situation, the current pay as you go system should be ending. In your review of plans that have been proposed, does any plan or, if so, which plan or plans will actually terminate the pay as you go system as we know it today?

Mr. BEACH. Congressman, none of the plans we have before you eliminate the pay as you go system in its entirety. I would suggest that perhaps Senator Gramm's plan comes closest because of the higher personal account percentage that you can put aside. But then again, all of these plans take a portion of the payroll tax and use that for retirement. The remaining portion is still pay as you go. It still supports the system as it currently is structured.

What they are trying to do—just close on this—what they are trying to do is fill a hole. It is not the hole that David referred to. It is a demographic hole. As you know, Social Security is based on pay as you go so it is based on workers. Those workers are going to be fewer in number relative to retirees in the future than they are today. That is a certainty, unless, of course, we have some miraculous thing hatch.

Mr. PENNER. There are plans like the Cato Institute's plan that I believe has been put into legislation by Congressman Porter that really do scrap the current system entirely. But even those very radical plans typically keep a minimum benefit of some sort that is financed on a pay as you go basis.

Mr. COLLINS. What you are saying is that there will be a social insurance program of some type that will exist for those who some way fall through the traps.

Mr. PENNER. I think, in my judgment and most peoples', it is not politically plausible to think that something as radical as the Cato Institute has proposed can pass.

Mr. BEACH. We have made a commitment that is not likely to be repudiated in the absence of complete economic chaos toward a social insurance system on many fronts. So at the Heritage Foundation while we don't have a plan yet that we are promoting as the Heritage plan, we nevertheless have five principles. One of those principles, I think principle number three, is that we have a two-tiered system, one tier made up of personal accounts and the second tier made up of this safety net. And a substantial safety net it will be in order to replace the demographic hole that is out there and maintain some kind of a minimum floor that everybody will have access to, no matter what their condition.

Mr. COLLINS. Thank you. That is all I have, Mr. Chairman.

Chairman SMITH. We will briefly entertain a second round of questions which gives me the opportunity for a couple more. In coming up with a solution now that would keep Social Security solvent forever, there is some question on whether we should try to address the problems of reaching 75 years and the problems we face after 75 years. Maybe each one of you can give me your comments and evaluations of solving part of the problem and moving toward a solution in incremental steps as we proceed into a future where there is less money coming in than is needed to pay Social Security benefits estimated around 2014. Coming up with a total plan now versus incremental changes. Any comments?

Start with you, Mr. Penner.

Mr. PENNER. I think that it would be highly preferable to come up with a comprehensive plan now for the reason we have already discussed. Then people will know what the rules are in the future. After all, retirement planning is a matter of 20 or 30 years for most people. And it would be good to have the rules stable so you aren't always tweaking them incrementally and forcing everybody to adjust to new rules all the time.

Chairman SMITH. Bill.

Mr. BEACH. I will defer to David.

Chairman SMITH. David.

Mr. JOHN. Actually also to address one of the points Mr. Collins raised, the one problem that you face with a wholesale restructuring of Social Security—a complete replacement of the pay-as-you-go system—is that you have a huge Social Security deficit that hits almost immediately. And while it does end sooner rather than later because the individual accounts build up fairly quickly, there will be a 20- or 30-year period with monster deficits.

As far as what is to be done, realistically, Congress could pass probably a 2, 3, or 4 percent account individual account. Preferably from our point of view, a carve-out from the existing tax would be the way to go. We also agree that the sooner that that is done, the easier the transition is going to be. Although under no circumstances is it going to be an easy situation.

There is also going to be a fair amount of education that is going to have to be undertaken before people can take responsibility for investing a certain amount of their Social Security money. And that is something that is also going to take time. Realistically, if we could start to put something in the schools at a fairly early date to teach people how to invest, that would be a very fine move to start out with.

Also, it is going to take a fair amount of time to develop the infrastructure whether we have an individual account that is run on a TSP model or an individual account where you basically go out and choose your provider. But no matter what, there is going to be a fairly healthy infrastructure that will have to be built. And it is something that doesn't really exist now, although it is certainly not impossible to develop. The sooner that Congress starts to lay down the marker and indicate which direction it is going to go, the sooner we will be able to work out details on that kind of plan.

Chairman SMITH. Representative Rivers, did you have additional questions?

Ms. RIVERS. Thank you. On page 8 of your testimony from the Heritage Foundation, the last paragraph gives numbers regarding annual deficits under the various systems for the year 2030. Is there an assumption within these numbers that none of the bonds, none of the treasury bonds will be redeemed?

Mr. JOHN. No, as a matter of fact what we are pointing out here and the reason that we chose 2030 was that that is within the time that the trust fund is being redeemed to pay benefits. The question comes how much money is going to have to be used to retire those bonds. Now, those bonds, as was mentioned in the paragraph from the OMB, President Clinton's——

Ms. RIVERS. So what you are presenting is you are presenting the debt owed in the form of the Treasury bonds as a deficit on the system.

Mr. JOHN. Yes. Because the thing is money is going to have to come in from outside the system, from outside the payroll tax in order to repay the bonds in the trust fund.

Ms. RIVERS. Okay. Which leads me to my second question, I will add, I asked questions earlier about the on-budget surplus and my concerns about the fact that it is predicated on real cuts in the budget, 20 percent in discretionary spending including defense. Given that, given that we have a Federal debt approaching 6 trillion and we have Medicare problems, that we have Social Security problems here, how much harder are these tasks going to be to address if we give a substantial tax cut at the current time?

Mr. BEACH. We made the point Congresswoman, that these numbers we presented today are based on various assumptions, demographic assumptions, economic growth assumptions and so forth, so that is one of the realities that we have to face. Tax cuts are important for reasons beyond Social Security, some would argue, and I would argue, that they are good for the economy, that there is a level of tax cuts which is important for economic purposes, equity purposes. We have——

Ms. RIVERS. I understand the reasons for it. My question is did it make the job easier or harder to deal with Social Security and our existing obligations if we give a tax cut right now?

Mr. BEACH. No, I think that you can separate the two one from another now. Now, you can't do that 10 years from now. Because 10 years from now this problem is a much worse problem than it is now.

Ms. RIVERS. But 10 years from now, tax cuts—if they are predicated on cuts that never exist, that never happen, don't we have an even worse problem not just with Social Security but with everything else that we are dealing with?

Mr. BEACH. No, I don't think so. I think if you have the kinds of tax cuts that a number of people across the spectrum are recommending, the capital gains, and on second earner bias, that you have a bigger economy, you have more jobs and have you a bigger tax base. And that is part of the policy judgment you have to bring to this issue.

Ms. RIVERS. I didn't bring this today for this reason, I brought it because I am looking for something else. But I have read this about four or five times. It is David Stockman's book. He tells us that what happened in 1981 is that a tax cut was predicated on the idea that the budget was going to be cut. The budget cuts never materialized. There was a hope that a tax decrease would, in fact, increase economic activity just like what you are talking about. And, in fact, none of those things happened, and we moved into the largest period of deficit spending that we have experienced as a Nation.

And my question, and I really want to address this in terms of problem solving, is we have some huge tasks in front of us, some real heavy lifting economically. We have to deal with redeeming the bonds and, as you say, the money has to come from somewhere. We have to deal with restructuring Social Security, we have to deal with Medicare. We are basing a surplus projection on cuts that this body has not been willing to make in the past.

How reasonable, how responsible—you are from the midwest, you are from Kansas, I am from Michigan, my training says to me, my upbringing says you don't spend money you don't have. You don't spend the same dollar twice. How reasonable is it to talk about doing all of these things with the same budget surplus?

Mr. BEACH. And my training also tells me that there is not a government program on the face of the earth that can't be made more efficient and better for the people that it is supposed to serve. Now, Social Security is a—as a retirement program has got to be fixed. It just has to be fixed. And by fixing it now, and then doing things to grow your tax base at the same time, you may be able to avoid major financial problems 2020 to 2050 period that are stemming from other things besides the issues that we are talking about today. We have $22 trillion worth of anticipated revenues over the next 10 years, counting Social Security revenues. We are talking about tax cuts between 300 billion and 800 billion over that time period that should be directed to help this problem and not hinder it.

Ms. RIVERS. With the Chair's indulgence I would like Mr. Penner to speak to it then I will finish.

Mr. PENNER. I tend to agree with you, Congresswoman. I don't think this is the time for tax cuts. I wouldn't say that were it not for the huge demographic problem that we face starting around 2010. But I would like to get the debt, the GDP ratio down a lot lower than it is today before I started talking about tax cuts. Especially tax cuts that would be promised for the year 2003 or so. There is just no reason to have to do that.

If the Congress follows its goal of trying to keep the unified budget surplus at least as large as the Social Security surplus with some kind of lockbox proposal, there is no room for tax cuts in the next few years even if you abide by the spending caps, which almost certainly you won't. I don't disagree with Bill that we could probably all go into a room together and find enormous amount of government waste that we could cut out.

Ms. RIVERS. But we all go into a room together, and we can't come up with things that can be cut, Congress.

Chairman SMITH. And that is our experience. Our experience is that government tends to grow. Right now taxes as a percentage of GDP are at the highest point they have ever been at in peacetime. And we have already got many proposals out there suggesting that we spend some of the surplus for other government programs that are so much needed. And so the argument is: should we get this money out of town to the extent that a surplus is another way of defining overtaxation. Is it reasonable at this time, to give some of that money back to the individuals that earn it? Can we do it in such a way that is going to be conducive to an expanded economy and a growing economy? That ultimately is going to be the solution.

If we simply take a larger piece of a smaller economic pie that might exist 30 years from now, and say these are our Social Security benefits, the system will shortchange younger workers. It is better for our retirees if we take the kind of actions that are necessary to expand the economy and enlarge the economic pie when they retire.

And did you have a statement, Mac, that you want to close on? Then I will ask each one of these individuals to summarize for a couple minutes if they would like to.

Mr. COLLINS. Well, Mr. Chairman, we talk about spending and talk about tax relief here for working folks around this country. You know, the budget resolution that the Congress passed was a resolution, it was the work of the Congress. It was a blueprint laid out by the Congress, no other branch of government was involved, just the Congress.

Now, if Members of Congress will follow the philosophy that our dear colleague on my left has just stated, then we will be able to follow through with that blueprint, that resolution, that will control spending, much different than is reported by Mr. Stockman's writing in his book of 1981. And in doing so, then we have fallen through with managing the people's business. And we will be able then to also pass and give tax relief to working people to leave more of their income to them, and they will spend it. And when people spend money, that has a tendency to increase and enhance the economy.

There are also some provisions in this tax proposal that Mr. Archer released just this morning that encourage divesting of assets and then reinvesting. And why is that important? It is important because—and I like to refer to a story of when I was campaigning in 1992, I walked in a little, small TV rental shop in Barnesville, GA, and the shop itself was about a third the size of this room. One lady was working in there. And I told her who I was and what I was doing. She says I want to talk to you about taxes. I said—I was a candidate; I would talk to her about anything.

She says I got this little piece of property out here at the edge of town that I could have sold three times. But I haven't sold it, and I am not going to sell it because I don't want to give a large part of the money to the government. I said, lady you are talking about capital gains. She says I don't know what you call it, she just said I know if I sell my property I have to give a lot of it to the government, and I am not going to do that.

Well, the gist of the story is this, she didn't sell that property. When she didn't sell that property, there were no profits made, no tax liability at all generated. So the Federal Government got no tax from it. The local system, the local government there got no money because there was no transfer tax on it, neither did the State recoup any kind of income tax because there was no sale, no tax liability.

So there are provisions of tax relief that can enhance the economy and grow the economy and help the situation that we face by creating more jobs and creating more revenue. And as we sit around, it is as 430 people on this end of the hall, 100 on the other end trying to make these decisions about how we are going to manage the people's money, the people's business, how we are going to by law force them to pay a portion of their income, they are sitting around a hundred million plus kitchen tables in this country trying to figure out their budget based on their income and the deductions from their income and the needs for the balance of that income that is left and how they are going to provide for their family.

So I think we can follow suit, and we can do exactly what we laid out in the resolution. And then once we do that, we send it down to the other end of the street. Then we bring into play the executive branch. And this executive branch then has the opportunity to either agree or disagree with what the legislative branch has done, and that is the work of the people's business.

Thank you, Mr. Chairman.

Chairman SMITH. Mr. Herger.

Mr. HERGER. Well, I want to thank the Chairman for having this hearing. I want to thank each of you for being here. I want to say that I sit on the same committee that my colleague Mr. Mac Collins serves on, the Ways and Means, tax writing committee. I don't know how anyone could say it more eloquently than he just said.

The fact is we are being taxed at the highest rate in peacetime history. When we allow working people to be able to keep more of their money, and we have done that several times under the Kennedy administration, under the Reagan administration, again a few years ago, I believe we have found out conclusively that very, very, very few people take that extra money and go bury it in the back yard. They go, and they pay off debts. They purchase things that they weren't able to before. And the multiplier effect, we end up having more than we did before, be able to take care of Social Security, particularly at the high rate we are being taxed now.

So I really can't add anything to that. I think it says it very well, the example he gave. I believe we could give a hundred other examples in other areas as well. So, again, this Social Security is an issue that we can't wait 15 years to take care of. It is something that we have to begin taking care of right now. And whether it be the thinking that those who are receiving it have or whether it be those of us as elected officials, we have to make the tough decision now, and it is a decision we have to make on a bipartisan basis. It is a decision we have to make, Senate, House, the President.

I am more encouraged now than I was before, it sounds like perhaps the President is moving more and more this way and others. And I believe probably only through the pressure of the American public are we going to do something. But I believe it is something we have to do right away. And again, Mr. Chairman, I understand this is the last of the hearings. I want to thank you for what I feel are very, very productive hearings. And I want to thank each of our participants for contributing. Thank you.

Chairman SMITH. And in summary, Mr. Herger, the Task Force decided earlier that we are going to recess today at the call of the Chair. A business meeting is tentatively scheduled for 1 p.m. this coming Thursday or at another time that will be appropriately announced. Any statements that individuals would like to have included in the Task Force report should be in by the 30th of this month. And the minority and majority statements likewise. And I would like to ask each of the witnesses today if they would have a concluding statement.

Mr. PENNER. Well, Mr. Chairman, I think all the important points have been made. But maybe the one that needs repeating is that this, combined with the Medicare problem, is the most important fiscal problem facing the Nation. It would be so much easier if we acted earlier rather than waiting until later. So I urge you on.

Mr. BEACH. About a year ago I was in south-central LA addressing a congregation of African and Methodist Episcopal ministers and church leaders on Social Security. Social Security reform for them is a problem of capital in their community. We toured the area several times Crenshaw, south-central LA, the place where Reginald Denny was pulled from the truck. The problem that these people have really isn't the glass sealing of civil rights. Congress, the President, the courts have provided the tools necessary to fight the civil rights problems, plenty of racism left in this country. The problem is the sticky floor of economic opportunity.

We need to find ways of using Social Security, the main way people say save for their retirement in those communities, to build capital in those communities through personal savings accounts. That is doing something inside Social Security. If you could do that, the economic benefits would be rather immediate, tangible in exactly the places where they need to be. So I urge this Congress to keep one thing in mind as you go forward, as Dr. Penner has said repeatedly, solving the trust fund problem is a couple of handles moved here and there and little bit of paint and basically you have got something done. Generational effects are going to be important.

The real objective here should be solving the retirement program for low and moderate income Americans, restructuring, changing that program to make it work for them.

Chairman SMITH. David.

Mr. JOHN. I have a 13-year-old daughter who is going to be retiring, with luck, about 2050 or so. If this Congress, or if the next Congress acts, she basically could be retiring at a time when the Social Security or deficit, is somewhere between $25 billion and maybe $8 billion. If you do nothing, the deficit is going to be $342 billion. Now what is that going to mean to her quality of life and the quality of life my grandchildren and, with luck, my great grandchildren?

Basically if you act now and if you act responsibly, and if you bite the bullet, there can be some sort of a reform that will make a tremendous amount of difference not just in terms of an operating deficit but in terms of the quality of life that she will face. As Bill was saying, allowing all Americans to participate in the economy through some sort of an individual retirement account gives people an opportunity that they never had. This is possibly the most important decision that is going to be facing this Congress or the next one.

Chairman SMITH. Well, again I thank each one of you for all the work that you have contributed to this effort. The Chairman handed out 14 potential findings that should be considered for Social Security changes. And without objection, those suggested findings will be included in the record. And with that, this Task Force is recessed for next Thursday at 1 or at the call of the Chair.

[The information referred to follows:]

BUDGET COMMITTEE SOCIAL SECURITY TASK FORCE 14 FINDINGS WE MIGHT BE ABLE TO AGREE ON

1. The current demographic projections may very well underestimate future life expectancy.
2. Investment in the capital markets is an important part of restoring Social Security 's solvency.
3. The investments should be limited strictly for retirement.
4. Guaranteed return securities and annuities can be used with personal accounts to ensure an investment safety net.
5. Social Security reform should encourage savings and overall economic growth.
6. Congress should consider paying for a portion of disability benefits for workers who have been in the system a short time out of the general fund.
7. Private or other capital investments can be managed to minimize administrative costs to avoid substantial reductions rates of return on investment.
8. We can learn from the experiences of other countries to more effectively develop Social Security reforms.
9. Any reform must consider the effects on all generations of workers and retirees.
10. The Social Security Trust Fund is a legal entity, but only becomes a financial asset when General Fund provides actual funding.
11. Time is the enemy of Social Security reform and we should move without delay.
12. Change should be gradual to allow workers to adjust their retirement plans and any change for current or near-term retirees should be minimal.
13. No payroll tax increase.
14. Social Security surpluses should only be spent for Social Security.

PREPARED STATEMENT OF HON. KENNETH F. BENTSEN, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I want to start by thanking you for your leadership on this panel and for holding these hearings. They have been, if anything, informative and insightful. I personally have learned more about Social Security, its successes, its problems, and potential solutions to achieve solvency.

I would like to spend the next few minutes laying out what I think are some key principles that all of us can take away from this Task Force.

First, I sensed that there is widespread agreement on the need to keep the Disability Insurance and Survivors' Insurance programs intact. If government should do anything at all, it should help those who cannot help themselves and protect widows and their children from poverty. No private insurance program would assume the disabled or those unable to work—children—as beneficiaries. They represent a perfect example of the problem of adverse selection. The Disability Insurance and Survivors' Insurance program is a sound safety net that should be maintained in its present form.

Second, it is also clear that Social Security is the most successful social program of the 20th Century. It, along with Medicare, has brought the poverty rate among our senior citizens down to 13 percent from almost 50 percent before its inception. That in and of itself is a tremendous accomplishment.

In spite of the program's achievements, it is also clear what is broken. The current program is fiscally unsustainable. Social Security is a pay-as-you go system where payroll taxes on current workers and their employers fund current beneficiaries. The basic problem is this: Social Security in its current form requires that the number of workers and the economy's payroll tax base expand faster than the number of beneficiaries and the size of their benefits. But demographic and economic trends have made this virtually impossible.

In about 10 years, 76 million baby boomers will begin to retire, and they are expected to live longer than their parents. The number of Social Security beneficiaries will double over the next four decades. Let me repeat that. The number of beneficiaries will double over the next four decades. At the same time, the number of workers will grow by only 17 percent. In 1950, there were forty workers for every retiree. In 1997, there were only 3.3 workers for each retiree. And that ratio is expected to fall to two to one in 2020. Under these conditions we cannot maintain current benefit levels with this kind of retirement boom.

So a proportionately smaller pool of workers—primarily younger workers and employers who pay the 12.5 percent payroll tax—will have to support a larger pool of retirees. Payroll contributions will only be able to cover 75 cents on the dollar of current benefits after 2055. The big question is how do we make up those 25 cents on the dollar or 2 percent of payroll?

Yet, this Task Force and the Congress should work to pierce the myth that the Trust Fund is an accounting fiction. Indeed, it is not. The Treasury Bonds invested in the Trust Fund are backed by the full faith and credit of the United States Government. The United States has never defaulted on its debt. In fact, Alexander Hamilton made debt repayment a significant part of his agenda as our nation's first Treasury Secretary. Since then, this nation has not backed down from debt repayment. To do so is unthinkable and irresponsible.

The problem with the Trust Fund is that while the dollars deposited in the fund are to be spent on general operations, they are credited to the Trust Fund and spent on general operations. Then, this increases in annual obligations ultimately increases debt and results in macroeconomic consequences in the future as total per capita debt grows and must be repaid. This puts additional pressure on fiscal policy. But while this practice has consequences for the general economic well-being of the U.S., it should be strongly noted that no obligation to the Social Security Trust Fund has been diminished.

Third, there are some credible plans that exist. Mr. Stenholm and Mr. Kolbe's plan, while I do not agree with all of its features, it is honest in that it meets fiscal considerations, such as transition costs and balanced budgeting. It also says there is no free lunch. Mr. Kasich's plan too is rather straightforward, although I may not agree with everything that is in there. Other plans, such as Mr. Archer's and Mr. Shaw's, show how difficult it is for a plan to be driven by ideology. Their plan does not differ much from the President's in the near term because all they do is commit future general revenues to the Social Security Trust Fund. Even worse, some have appeared before this Task Force with plans that promise ever lasting economic growth and higher than average returns on equity investments. While investments in equities have generated higher returns on average when compared with T-bills, there have been some periods of time when there have been negative returns. Seven times in the 1970's and 1980's the real value of the S&P 500 was at least 40 percent below what it had been in the previous 10 years. What is really a tragedy is when private interest groups put forth plans without saying how they are going to pay for them and do not take into account transition costs. Those plans are just not credible.

Finally, I want to emphasize again what Mr. Greenspan said privately to the Task Force. He favors a more privatized system or, at least, if I can read into what he said, individual accounts, because he is a conservative. He believes the value of placing a greater burden on an individual to save for his or her retirement makes for a better society; it does not necessarily make for a better retirement program. In fact, a private system does not have to be pre-funded and can have the same liabilities as our current system. Just because a system is privatized does not mean that it will not have the same liabilities as a pay-as-you-go system. Solvency is not the same as reform and just because a system is reformed does not mean that it is solvent. His preference for a private system is based, in large part, on macroeconomic theory and he clearly stated that a system of private accounts is no more solvent or sustainable if the current the current public system.

For example, a privatized but unfunded pension system has recently been established in Latvia, where payroll taxes are collected by the government, which then credits workers' so-called "notional" accounts with paper returns on contributions. Singapore, on the other hand, has a public retirement benefit that is pre-funded where the central government collects taxes sufficient to generate substantial assets, which it then invests on the systems behalf.[1]

[1] This paragraph is extrapolated from a paper by John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes. "Would A Privatized Social Security System Really Pay a Higher Rate of Return?" (Latest draft, August 3, 1998).

The bottom line is that a plan to extend the solvency of the system is needed and such a plan should be enacted sooner rather than later. Solvency may include, but does not have to include, radical overhaul of the current system. Any system should maintain the basic characteristics of the existing system with respect to the principles of universality and progressivity. And, any reform plan, must indicate upfront how it is paid for and on whom the burden falls. Mr. Chairman, our work is cut out for us. There are hard decisions that have to be made and I hope we can do this in a bipartisan, constructive manner. Thank you.

PREPARED STATEMENT OF HON. EVA M. CLAYTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. Chairman, preserving Social Security is one of the most important issues that we face today. We finally have a balanced budget which gives us an opportunity to save and strengthen Social Security. It is the obligation of this Congress to protect the financial security and promised benefits that so many of this nation's retirees are depending on when they retire within the next 10 to 15 years. Additionally, it is through Social Security that we must ensure the economic future for our children and grandchildren.

Social Security has been one of the country's most successful social programs. It is largely responsible for the dramatic reduction in poverty among elderly people. Half of the population aged 65 and older would be living in poverty if it were not for Social Security and other government programs. Social Security alone lifted over 11 million seniors out of poverty in 1997, reducing the elderly poverty rate from about 48 percent to about 12 percent. Social Security has become more effective in reducing poverty over time.

Strategies for saving Social Security for future generations is probably the most significant debate facing us. We want to make sure that the future of Social Security is secure for our children and grandchildren, but we also want to protect the financial security and promised benefits of retirees. It is important for Congress to remember that while Social Security was not designed as a retirement program, many Americans have paid into the system in good faith and feel justified in relying on these benefits to survive in their retirement years.

The Social Security system is projected to have long-range funding problems. Therefore, we must find a way to reform this system. The House Budget Committee Social Security Task Force was formed with the intent to look at the various reform proposals, problems that different generations and genders have, and possible solutions to these problems. We have held hearings, and as a result, have defined eighteen bipartisan statement findings.

Mr. Chairman, one particular area that I would like to focus on is consideration of the effects reform will have on all generations, genders, and minorities. Social Security is particularly important to people of color. Elderly African Americans and Hispanic Americans rely on Social Security benefits more than white elders rely on the program. Social Security benefits make up 43 percent of the income received by elderly African American people and their spouses and 41 percent of income received by elderly Hispanic Americans, compared to 36 percent of the income of elderly whites.

Social Security is also an important source of income for women. The program made up 61 percent of the total income received by elderly women in 1997 and it was the only source of income for one out of five elderly women. Women have fewer resources to draw upon in their older years than do men. Only 30 percent of women 65 and older had pension coverage in 1994 while 48 percent of men were covered.

While Social Security is intended to be only one source for retirement income, the lack of pension coverage and limited resources for savings places greater weight on Social Security as a reliable, guaranteed source of income for minorities.

Mr. Chairman, thank you for holding these hearings since ensuring that Social Security remains intact is so important to the livelihood of many people. The questions and problems surrounding Social Security, as well as the impact on every U.S. citizen, certainly justifies a close examination by Members of Congress.

PREPARED STATEMENT OF HON. RUSH D. HOLT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. Chairman, it has been a pleasure to serve with you and other members of the Social Security Task Force throughout the past several months. Preparing for the retirement of the baby boom generation looms as one of our nation's most difficult challenges, and I commend the efforts being made here to develop a long-term solution.

Social Security—the nation's largest and most successful domestic program—has reached a critical juncture in its development. When Social Security was passed, to be old was usually to be destitute—Social Security changed that. People in the U.S. believe it is a fundamental value to help workers save for retirement.

As its creators anticipated, nearly every wage earner now pays taxes into the system. In principle, all citizens may be eligible for entitlements at some point in their lives. Yet senior citizens worry that their benefits will be cut; younger Americans are skeptical about their own benefits upon retirement.

If the government were to do absolutely nothing to Social Security, the Social Security Trust Fund would still be solvent for about 35 more years. There is no immediate Social Security crisis. But because the issue concerns every American, it is critical that the debate on Social Security reform be based on a deep understanding of the economic and social underpinnings of the system. This Task Force has augmented my personal learning process and for that I am appreciative.

Although the Social Security system is now running surpluses, its board of trustees projects that its trust funds will be depleted in 2034 and only 71 percent of its benefits will then be payable with incoming receipts. The trustees project that, on average, over the next 75 years, the system's cost will be 15 percent higher than its income; by 2075 it would be 49 percent higher. The primary reason is demographic: the post-World War II baby boomers will begin retiring in a decade and life expectancy is rising. By 2025, the number of people age 65 and older is predicted to grow by 75 percent. In contrast, the number of workers supporting the system is expected to grow by only 13 percent. As a result, the ratio of workers to recipients is expected to fall from 3.4 to 1 today to 2.0 to 1 in 2035.

Trustees project that the surplus Social Security taxes now being collected will cause the Social Security Trust Funds—comprised exclusively of Federal bonds—to grow to a peak of $4.5 trillion in 2021. The system's outgo would thereafter exceed its income and the trust funds would fall until their depletion. However, the trustees also project that the system's taxes (ignoring interest income) would fall below its outgo in 2014. Interest paid to the funds is simply an exchange of credits among government accounts. It is not a resource for the government—only the system's taxes are. Hence, it is in 2014 that other Federal receipts would be needed to help pay for benefits. If there are no other receipts, we would have three primary options: raise taxes, cut spending, or borrow the needed money.

Public opinion polls show that fewer than 50 percent of Americans are confident that Social Security can meet its long-range commitments. We have also heard testimony that Social Security may not be as good a value in the future as it is for today's retirees. These concerns and a belief that the remedy lies partly in increasing national savings have led to proposals to completely revamp the system.

Some witnesses suggest that the system's problems are not as serious as sometimes portrayed. They argued that the system is now running surpluses, that the public still values the program, and that there is risk in some of the new reform ideas. They contend that only modest changes are necessary.

In our Social Security Task Force, we have considered ideas ranging from restoring solvency with minimal alterations to totally replacing the system with something modeled after IRAs or 401(k)s.

I agree with the Committee for Economic Development that there are three primary goals for reform that address the central problems of Social Security—fiscal imbalance, declining returns, and the resulting loss of confidence among young workers. When crafting solutions to achieve basic reforms, we must keep in mind the key principles of restoring the system's solvency, preserving Social Security as a safety net, reducing inequities in the system, and raising the national saving rate.

We Americans have made Social Security one of our most useful and basic commitments to younger and future generations. We cannot let the Social Security system slide toward insolvency and allowing confidence in the system to erode, especially among young workers. To do so would undermine one of the most successful and important programs of the 20th Century.

The nation can—and should—keep its commitment to future workers as well as to today's retirees. Social Security provides reliable income that is critical to millions of retirees in this country; it is the primary means of cash support for nearly all retired low-income workers. To abandon Social Security would be to cast millions of future retirees adrift to fend for themselves. Sensible reforms, building on existing structures and drawing on the productive power of this country's private economy, can ensure a healthy Social Security system for America.

But the nation must act promptly. Delay is unwise and dangerous. It will raise the cost of reform and is unfair to future generations. The most compelling reason to act soon, however, is to reverse the alarming erosion in popular support for Social Security, especially among younger workers.

It is well within the resources of our country to provide support for our retirees and other who receive payments under disability. It is no secret that at this time, our nation is enjoying a budget surplus. I believe that every penny of the entire budget surplus, not just the Social Security surplus, should be saved until legislation is enacted to strengthen and protect Social Security first.

Spending any projected budget surpluses before protecting and strengthening Social Security would be wrong. Projected budget surpluses over the next decade offer a once-in-a-lifetime opportunity for addressing the challenges that Social Security faces. This hard-won achievement resulted from responsible steps that were taken in the past. We should not deviate from the path of responsibility now, with problems looming over the horizon for Social Security.

Mr. Chairman, Social Security is the most important and successful program of the 20th Century. We must not forget that it provides vitally important protections for American seniors. A majority of workers have no pension coverage other than Social Security, and more than three fifths of seniors receive most of their income from Social Security.

Let's put the need of America's current and future retirees first. Thank you.

PREPARED STATEMENT OF HON. PAUL RYAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

I want to take this opportunity to provide my conclusions on the work of this Task Force in the past few months and congratulate the Chairman of the House Budget Committee Social Security Task Force, Mr. Nick Smith, for his leadership on Social Security and this special Task Force. The hearings we held have provided a good opportunity to facilitate the dialogue on both sides of the aisle. The bottom line for Social Security, however, is that Social Security cannot and will not survive in its current form. It faces the grave reality of insolvency within the next few years if we do nothing.

On the other hand Congress and this Administration now have the opportunity to address this pending insolvency. One of my highest priorities in Congress is Social Security. There are many important steps that need to be met in order to, first, protect the Social Security Trust Fund, and second, improve Social Security for current retirees and future generations. In addition, before any changes are made to Social Security, I believe it is important to guarantee current benefits to current and future beneficiaries.

First, to guarantee these benefits, earlier this year, I introduced the Social Security Guarantee Initiative, H.J.Res. 32, which would guarantee benefits to current and future retirees as we work to improve Social Security. It passed overwhelmingly in the House. This needs to be a fundamental ingredient to any initiative to save Social Security.

Second, I introduced and cosponsored Social Security "Lock box" legislation which would change the rules of the House of Representatives to help us stop Congress from passing legislation that dips into Social Security. For years, the Federal Government has been taking money from the Social Security Trust Fund to pay for no-related government programs.

In addition, I, along with the Chairman of the House Budget Committee, Congressman John Kasich, have introduced the Social Security Surplus Preservation and Debt Reduction Act, H.R. 1803, which would establish a new enforceable limit on the amount of debt held by the public. The debt ceiling would be reduced as the debt is paid off. A point of order would lie against any legislation, in the House or the Senate, which would increase the public debt limit or provide borrowing authority that exceeds the debt held by the public.

Finally, I am still in the process of evaluating each Social Security reform proposal. I have heard from many of my constituents in the District and will be looking very carefully to see whether each proposal would:

- Increase the rate of return for payroll taxes paid into the Social Security Trust Fund.
- Not increase the Federal Government's role in Social Security.
- Continue to provide a safety net for retirement income.
- Not decrease benefits.
- Not increase taxes.

Again, reforming Social Security is a priority for me this Congress. I look forward to working with my constituents and my colleagues to improve Social Security for the current and future generations.

[Additional resource on Social Security privatization submitted by the Budget Committee minority staff follows:]

INTERNET LINK TO NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER, "WOULD A PRIVATIZED SOCIAL SECURITY SYSTEM REALLY PAY A HIGHER RATE OF RETURN?"

http://www.nber.org/papers/w6713

[Additional resources on Social Security reform submitted by Mr. Smith follow:]

PREPARED STATEMENT OF WILLIAM G. SHIPMAN, PRINCIPAL, STATE STREET GLOBAL ADVISORS

Chairman Smith, Congresswoman Rivers and Members of the Task Force, I thank you for giving me the opportunity to submit testimony to the House Budget Committee Task Force on Social Security concerning administrative costs in a reformed Social Security system. I come before you as an interested citizen who has spent his career in the financial services industry. I am a Principal of State Street Global Advisors, an investment management firm that is part of the State Street Corporation.

Founded in 1792, the State Street Corporation is committed by our corporate plan to "Participate in the governmental process, and contribute our efforts and resources to serving the common good." In that spirit, we have participated in the national debate over ways to strengthen and revitalize America's Social Security System. In response to numerous requests, we have examined the technical and administrative costs and challenges that would arise in creating a national system of individual investment accounts. Our analysis, based upon our extensive experience in administering pension funds and 401(k) plans, does not advocate any specific proposal or its financing.

Moving to an individual account system is a significant and unprecedented undertaking. To put it into perspective, at year-end 1994, the latest government data available, there were about 200 thousand 401(k) plans, and about 21 million individual participants. Given the growth since then it is presently estimated that 25.4 million individuals now have 401(k) accounts.[1] The individual account system we are discussing here would be more than five times the size.

Many, if not most, analyses of administrative costs have approached the issue by looking at what other countries have done, estimating their costs, and then projecting that those costs reasonably would be borne by the United States, as well, if we were to move to a market-based structure. We took a different tack. We looked at individual account systems in our country and wondered if they could be applied to this challenge. We concluded that they could.

This testimony is in four parts. The first is a description of the objective of a market-based system. The second is the summary of a model currently in use that meets the objective. The third is the significant challenge in applying that model to Social Security reform given present accounting and record-keeping systems. And the fourth is a solution that overcomes the challenge.

The feasibility analysis conducted by State Street is just that—a feasibility study—and does not advocate one course of action over another.

THE OBJECTIVE: AN INDIVIDUAL ACCOUNT, MARKET-BASED SOCIAL SECURITY OPTION

The objective is to develop an investment and administrative plan that:

- Creates individual accounts with assets owned by the account holder;
- Ensures reasonable costs for all participants, low- as well as high-income workers;
- Minimizes employers' administrative burden;
- Provides the opportunity for workers of all incomes to invest in capital markets;
- Ensures that inexperienced investors will not suffer poor returns relative to experienced investors;
- Provides investment choice;
- Offers a solution for workers who make no investment choice;
- Automatically adapts to changing technology and services offered by the financial services industry.

These objectives are considered important because they have been central in the debate on Social Security reform. They are also integral to the most popular defined

[1] Spectrum Group, San Francisco, CA.

contribution system in the United States, the 401(k) plan.[1] Indeed, the 401(k) plan structure is often referenced as a potential model for an individual retirement account plan for Social Security. It should be noted that even though the 401(k) plan may be a useful model, it is unlikely that it would be applied precisely.

THE MODEL: THE 401(K) PLAN

Since the late 1970s, defined contribution systems have increased in popularity among American companies and workers. And just since 1985 those that have sponsored as well as those that have participated in 401(k) plans have increased several fold.

Under 401(k) programs, a plan sponsor, usually a company or union, oversees administration of a savings and investment program for its employees. Under such plans:

- Employees opting to participate in the program designate the amount they wish deducted from their pay;
- Employees select investment options prescribed by the plan sponsor;
- The plan sponsor deducts the specified funds from the employee's pay and in many cases invests the funds as of that day in the designated investment vehicles;
- Deductions are made on a pre-tax basis;
- Investment earnings grow on a tax-deferred basis;
- Benefits are subject to tax when taken out;
- In many plans, the employer provides some level of matching contribution to the employee's account;
- Account holders normally can call an 800 number voice response unit or individual account representative and change their portfolio holdings and receive that day's closing price for each asset traded.

In the early years of 401(k) plans investment options were often limited to a stable value fund, a diversified fund and company stock. In recent years, however, there has been a significant increase in investment choice. Many plans now include a large number of investment options as well as self-directed brokerage accounts. These accounts provide access to a large universe of institutional and mutual funds as well as individual securities. With all of the choice available, individuals can now create portfolios that are appropriate for their age, their risk tolerance, and their wealth objectives.

THE CHALLENGE: THE GOVERNMENT'S RECORD-KEEPING AND ACCOUNTING SYSTEM

The major challenge in creating a 401(k) model of individual accounts linked to Social Security is the timely posting of individuals' savings contributions. This is not possible given the present Social Security record-keeping system.[3] Although the Treasury Department has built a comprehensive system for the collection of FICA taxes from employers, there is no detailed record of individual taxes paid at the time they are collected and sent to Treasury. This information is not communicated to the government until the following year.

Companies remit FICA taxes in lump sums throughout the calendar year, but do not forward to the government at the same time the names of the individual employees who paid those taxes or the amount each paid. That information isn't provided to the government until the next calendar year when the employer sends W-2 forms to both the government and the employee. Treasury knows throughout 1998, for instance, that a company has paid a sum of FICA taxes for its employees, but the Social Security Administration will not update its records until late June of 1999, and possibly a few months later, with the names of the individual workers who paid those taxes and how much each worker paid. The government never knows when during the year the individual paid the taxes. This recordkeeping process, although workable in Social Security's defined benefit structure, is unworkable in a daily environment defined contribution structure. But it is all that currently exists for identifying individual payroll taxes.

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[2] Profit Sharing/401(k) Council of America. "Helping Americans to Help Themselves: The Role of Profit-Sharing/401(k) Plans in the Retirement-Income Security Framework." http://www.psca.org/role.html.

[3] See, for example, Kelly A. Olsen and Dallas L. Salisbury, "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs." EBRI Special Report and Issue Brief #203.

THE SOLUTION: A THREE-LEVEL APPROACH

A solution is to structure investment options, not all of which require timely and detailed contribution data. This approach involves three investment levels.

At the first level, workers' savings are deducted from payroll and invested in a collective money market fund. Workers own the assets of the fund although the accounting at the individual level is not completed until the following year. This reconciliation is accomplished with the filing of the W-2 form. When the individual's assets are accounted for, units in the money market fund, which include earned interest, are then posted to each worker's account. The fund is dollar priced which means each unit is valued at one dollar.

The units are then invested in one of four funds—three balanced funds and a money market account—selected by the worker. Individuals who do not or choose not to make a selection have their assets invested in a default option.

The account holder has the option—after a startup of about three years, a period required to successfully build up assets to achieve economies of scale—to transfer some or all of his balance to an appropriate retail retirement account.

LEVEL ONE INVESTMENT: A POOLED MONEY MARKET ACCOUNT

This pooled account would be a conservative fund similar to a large institutional money market fund. The funds would be held in this pool earning interest for all participants. Given that the timing of an individual's contribution is not known, all participants are assumed to invest on June 30th. The effect of this accommodation is that interest earned is one half of what it would be if one started investing in January. The loss, or gain for those that start working in the latter part of the year, is not significant in most cases. For example, an average wage worker making about $28,000 and contributing 4 percent of wages throughout the year and earning 5 percent interest incurs a loss of about $13. For average wage workers who work intermittently during the year the loss is most likely less. High-income workers, however, effectively subsidize low-income workers because high-income workers contribute a disproportionate amount of their income during the early part of the year.

Each worker would know during the year how much is invested because it is the same as the year-to-date reduction in the FICA tax that goes to savings, often referred to as the carve-out. The carve-out may be itemized as a separate line item on the pay stub. Interest would always accrue, so the account balance would be in excess of the contribution. All workers, regardless of income, would receive an identical rate of return. Funds would remain in the money market account until the reconciliation of how much each worker contributed, about August of the following year.

LEVEL TWO INVESTMENT: BALANCED FUNDS

When the individual account balance is determined it is converted to units in one of three balanced funds that the worker chooses. Balanced funds are diversified portfolios that are generally invested in stocks, bonds and cash. The combined assets underlying very successful private employer-sponsored defined benefit plans are essentially balanced funds. One of the Level Two balanced funds may have an allocation that closely approximates these plans. This allows all workers, if they wish, to maintain an asset allocation similar to that provided to the employees of many sophisticated corporations in the world. There would be another fund on each side of this fund: one for younger workers that would be weighted more toward equities, while the other would be weighted more toward bonds for those closer to retirement.

Although workers could choose their balanced fund, some may not. In this case, they would default to the middle fund. In other words, a worker—perhaps low income and financially unsophisticated—would be invested in a well diversified balanced portfolio suited for retirement savings. The portfolios would be managed by professional asset managers chosen through an open and competitive bidding process. Index fund investment management fees most likely would be less than two basis points (bps): two one-hundredths of one percentage point. The balanced funds would be valued daily and prices would be published in the popular press. Workers only need multiply their units by the daily price to monitor their account balance.

LEVEL THREE INVESTMENT: ROLLOVER OPTION

After a period of perhaps three years, a period required to successfully build up the assets in the Level Two account system to realize economies of scale, investors seeking more investment choice would have the option of rolling their investment funds out of the Level Two asset allocation funds and into any qualified retirement investment account.

Those choosing Level Three would transfer assets to a qualified account with a financial services company meeting reasonable and specified standards.[4] While investors would have a wider range of choice within Level Three, there still would be reasonable investment guidelines. In Level Three investment managers would act as the fiduciary for their product offerings and be subject to Department of Labor oversight. This is consistent with many employer-sponsored plans, both defined contribution and defined benefit.[5]

Level Three might well suit those workers who have a high degree of confidence in a particular money manager, a particular firm or a particular style of investing. It will also serve investors seeking a type of investment unavailable in the Level Two asset allocation funds. An investor, for example, may wish a greater concentration of equity investments than is available in the asset allocation funds. Should a worker find a particular Level Three provider or product unsatisfactory, the worker could transfer to another provider or move back to Level Two. This assures competition across Level Three as well as competition between Levels Two and Three. Competition will ensure the lowest cost and best service for the entire system.

Record-Keeping and Administration

The administration of an individual account system will require the development of a large-scale, customized record-keeping system with the capability to produce a highly efficient service solution. The efficiency of the service application will be dependent upon the design and execution of the system. There is no existing application that meets all the requirements.

The requirements to support a national individual account system will be complex, large-scale and capital intensive. As noted above, this is a challenge of unprecedented scope.

Nonetheless, the application itself is relatively straightforward. Development time can be minimized to allow focus on sizing and scaling the network and building the necessary interfaces to the Social Security Administration (SSA). Unlike mutual fund or 401(k) record-keeping systems, there will not be many unique product features or functions, thus significantly reducing complexity and cost. It is reasonable to assume a system could be developed in 12-18 months to support these requirements.

The greatest challenge in building a record-keeping system to support the requirements of an individual account system is not the complexity of the application, but the need to support the high volume of participant inquiries, transactions, transfers and report generation. To keep costs low, it is critical that most participants utilize voice and Internet technology to obtain information and transact business. The greater the percentage of calls that requires a customer service agent the higher the administrative cost.

The volume of calls will be driven by the frequency of transactions and statements, as well as average account size and market volatility. Assuming 140 million accounts and the plan described, participant call volumes are projected to range from 175 million to 350 million annually. In addition, the system will issue 140 million statements, process fund transfers and distributions. This approach assumes the funds are priced daily and accounts updated nightly.

Whether the record keeping is done by a government entity such as the Social Security Administration or out-sourced to the private sector, this task will require the formation of a large service organization to support these requirements. The service firm would need call centers in multiple locations around the country and would need to hire between three and seven thousand employees. For the purpose of this analysis, it is assumed that the Social Security individual account system will incur volumes between 0.5 and 1.0 calls per participant per annum.

Another important factor in projecting costs is determining what percentage of the participant's call volume will be processed by voice response and Internet technology versus requiring the services of a call center representative. The cost to handle calls using the technology is a fraction of the cost to process through a representative. Therefore, to achieve an efficient solution it is critical that high levels of automation

[4] This process should be fully automated and driven by a third party, such as the National Securities Clearing Corp. At the individual account holder's instructions the Level Three provider should be able to initiate the transfer and cause the money to be moved from Level Two to Level Three without having to provide any paperwork.

[5] Department of Labor Pension and Welfare Benefits Administration. "Study of 401(k) Plan Fees and Expenses." April 13, 1998.

are achieved. The analysis assumes 85 percent of the call volume will be handled through voice and Internet technology, comparable to the levels currently achieved in many large defined contribution plans. Estimated first year expenditures will range from $473 to $922 million.

COST MODEL

Based on the plan design defined above, a cost model has been developed to project the administration costs under a range of assumptions. The unit cost factors are based on experience in the 401(k) business and have been adjusted in some cases to account for the scale of the individual account option. The requirements of a national system of individual accounts are unique and, therefore, extrapolations from 401(k) experience pose some risks. Unlike the 401(k) structure we assume that in a timely fashion the Social Security Administration will provide the individual account recordkeeper an accurate, automated transmission of earnings' histories that will be used to calculate annual contribution data. These and any other expenses associated with reconciling W2 records are to be borne by Social Security and are not included in this cost model. It is also assumed that Social Security, at its cost, will maintain accurate and up to date employee address files, as will be necessary anyway with the annual mailing of Social Security statements starting in 2000. We envision that one's investment account statement would be included in this mailing.

Another cost not included in this model is the expense associated with communicating this program to employees. The assumption is that the government would bear these expenses. Therefore, they expressly are not included in the asset based fees reported below. There is precedent for this in that the government pays directly some of the communication expense of the Federal Thrift Plan.

COST SUMMARY

Based on the design criteria outlined and our unit cost assumptions, it is projected that the first year's administrative expenses to support an individual account system will range from $473 to $922 million. Assuming 140 million accounts this translates to a cost per account range of $3.38 to $6.58 in the first year. Although costs would be expected to increase annually driven primarily by employee compensation and benefits, assets would increase more rapidly. Costs as a percent of assets, therefore, would fall. We project that steady-state asset based costs would range from 19 to 35 basis points.

These costs are competitive with other investment products. For example, the Federal Thrift Plan, which is often used as an example of an efficient retirement plan, had an expense ratio of 65 bps in its second year. Another benchmark is a portfolio of individual mutual funds representing different asset classes and weighted to approximate a Level Two balanced fund. Such a portfolio is presently available for a total cost of about 40 basis points.

FINAL COMMENTS

Although many approaches to the administrative challenges inherent in an individual account system linked to Social Security may be expensive, not all need to be. Under reasonable assumptions, a well thought out plan that meets our nation's retirement needs is affordable.

PRESENTATION ON INDIVIDUAL ACCOUNTS BY EBRI

IA's: Administrative Cost

Dallas L. Salisbury

The Employee Benefit Research Institute

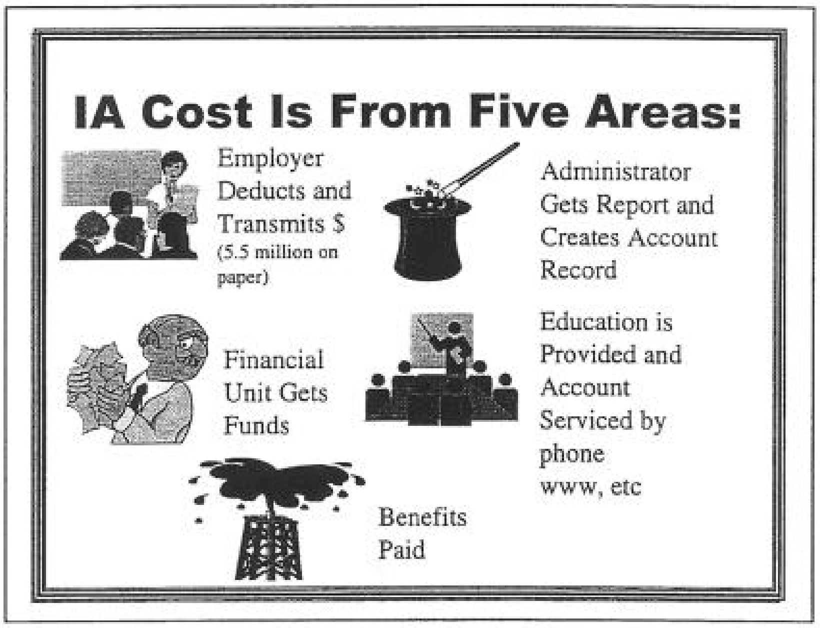
www.EBRI.org

March 11, 1999

Individual Accounts Will Have Substantially Higher Administrative Costs Than SSA - And Costs Matter

SSA is now $10 per covered life per year, of which $9.30 relates to the annuitization and benefit payment function.

Studies from advocates have presented rates of up to $55 to $117 per covered life per year, with no cost included for education or annuitization.



What Cost Estimate ?

- 140 million voice calls at $4
  - $560 million
- Voice Response at .10
  - $14 million
- Staff at 1 per 100,000 participants
  - 1400 people

- 140 million voice calls at $13
  - $1,820 million
- Voice Response at $1
  - $140 million
- Staff at 1 per 1000 participants
  - 140,000 people

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Estimated Cost

- 70,000 fte's at $50,000 or $3.5 billion total
- Employee questions at mid cost or $1.3 billion
- $31 dollars per participant per year
- Worker investment education at $30 or $4.2 billion
- Start up system and software - three years and $500 million or $3.57 per
- EBRI DC Plan $725 plus investment fees

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Small Employers and Low Income Workers Key Issues

- Small employers want no added administrative burden and are willing to pay little in added cost.
- Small employers want no added dollars added, they want reallocation of exisitin payroll taxes
- There are a lot of low income workers

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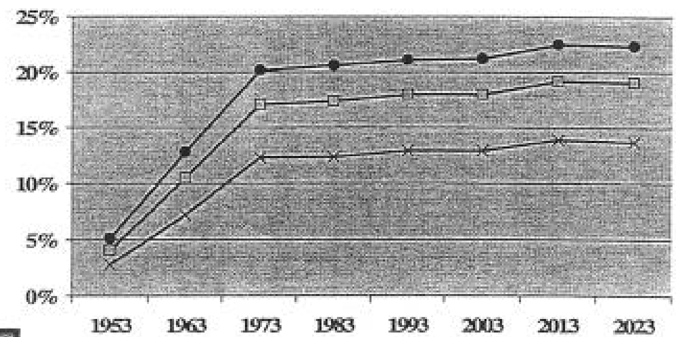
Administrative Costs Matter

percentage reduction in male's benefits going from low to high cost by birth cohort, S. 2313-NCRP



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How is Social Security Different from DC Plans?

1. It's **Bigger** ⇒ covers more than 7x the # of k participants
2. Covers *different* people and employers
3. benefits vs
   Credit-based Cash
4. Technology Differences — *5.5 million report on paper to SSA.*

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Workers and K by Income

ALL WORKERS

	# of workers	% of workers	offered k	participate
Total	143,193,461	100%	36.8%	23.8%
annual earninngs				
less than 5000	27,150,605	19%	8.1%	1.6%
5000 to 9999	14,253,227	10%	13.1%	4.4%
10000 to 14999	15,098,961	11%	22.7%	10.0%
15000 to 19999	13,771,471	10%	35.7%	19.5%
20000 to 24999	13,535,457	9%	43.9%	26.7%
25000 to 29999	11,212,714	8%	46.5%	46.5%
30000 to 49999	29,455,411	21%	57.1%	57.1%
50000 or more	18,715,615	13%	67.6%	67.6%

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Linking Contributions to Workers - W-2 Reports

How Social Security Works:

Jan.'98. You Earn $700 in January 1998

Employer Schedule. Employer sends FICA tax on $700 to Treasury along with income taxes for you and all your coworkers on employer's schedule

Jan-Feb.'99. W-2 reports that $700 reported to SSA by.

July-Sept.'99. Wage credit posted to your record

(at earliest)

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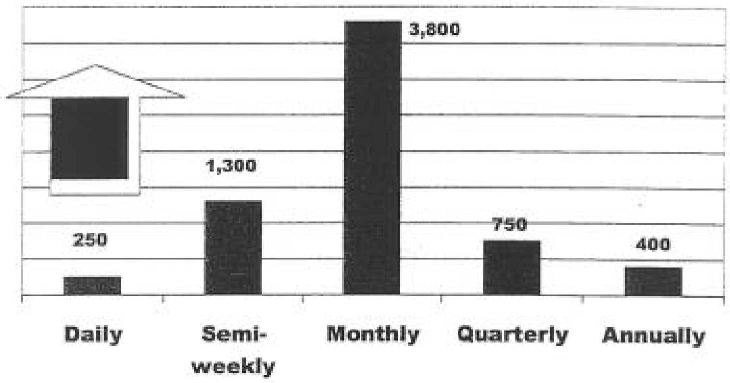
EBRI *Issue Brief*, November 1998.

Thousands of Employers by Tax Deposit Schedule, 1997



Source: Unpublished Data, Social Security Administration, 1998.

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Trade-Offs

- ⇨ Employer Burdens
- ⇨ Worker Liability
- ⇨ Government Involvement / Liability

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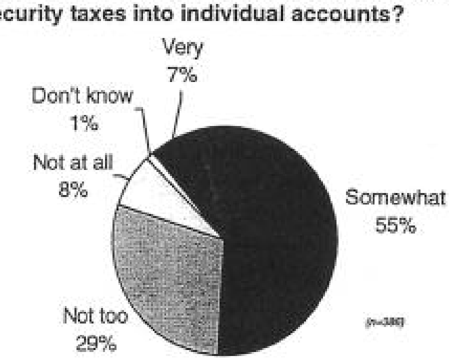
1998 Survey of Small Employers on Social Security Individual Accounts

Knowledge of Social Security Individual Account Proposals

How knowledgeable do you feel you are about reform proposals that would allow individuals to divert a portion of their Social Security taxes into individual accounts?



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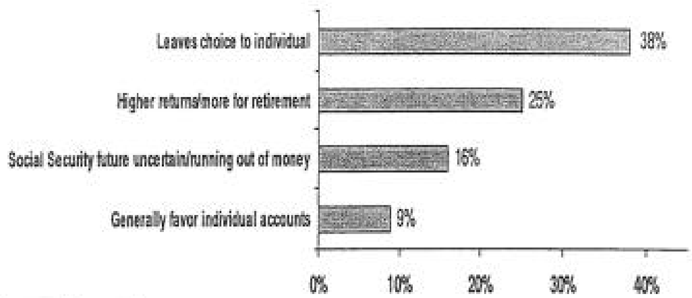
Reasons for Favoring Social Security Individual Accounts

Why do you favor this type of reform?



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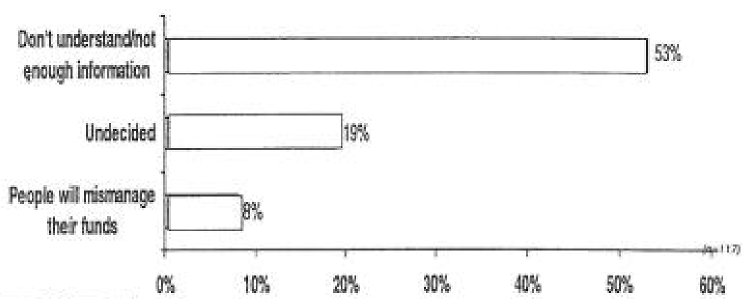
Reasons for Being Neutral About Social Security Individual Accounts

Why do you say you are neutral about this type of reform?



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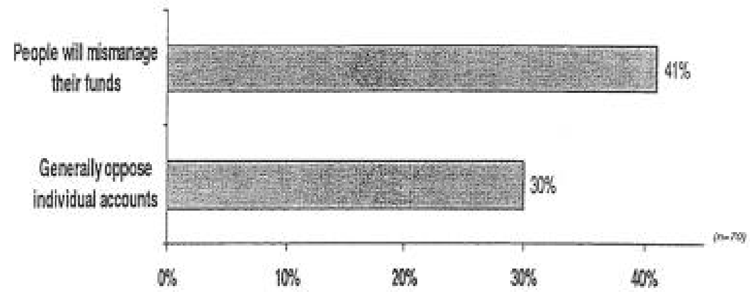
Reasons for Opposing Social Security Individual Accounts

Why do you oppose this type of reform?



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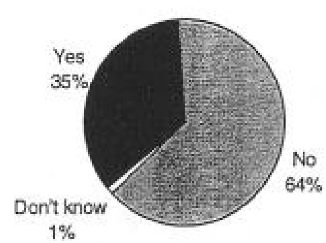
Thought About Administering Social Security Accounts

Some of these proposals would involve setting up an individual Social Security account for each worker and employers might be required to help administer the individual Social Security accounts system. Have you thought about this?



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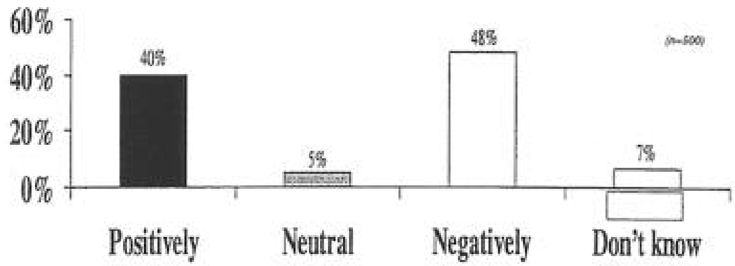
Feelings About Administering Social Security Accounts

As an employer, how would you feel about helping to administer this individual Social Security account system?



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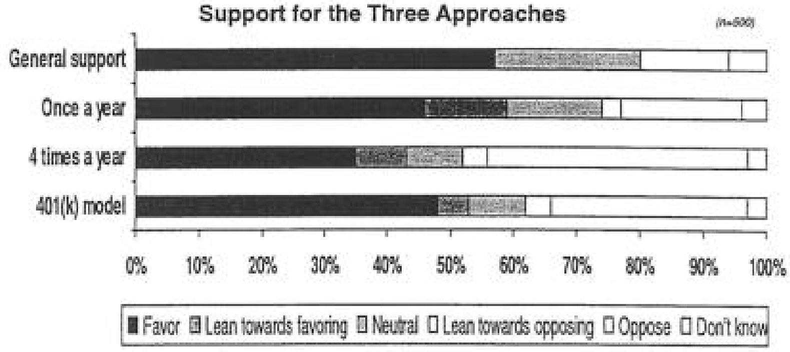
Comparison of the Three Approaches to Implementation

Support for the Three Approaches



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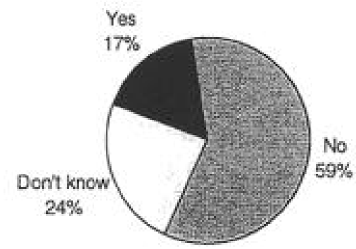
Opposition to Employer Administration

Suppose the only way an individual Social Security accounts system could pass Congress was if employers were required to help administer it. Is there any type of system that you, as an employer, would favor?



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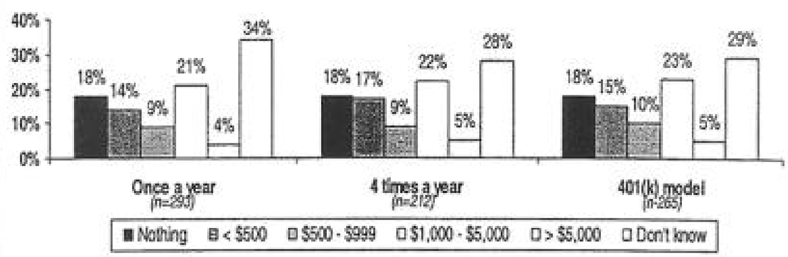
Amount Small Employers Are Willing to Spend

What is the maximum amount of money you would be willing to spend on an annual basis in additional payroll processing costs and still favor this system?



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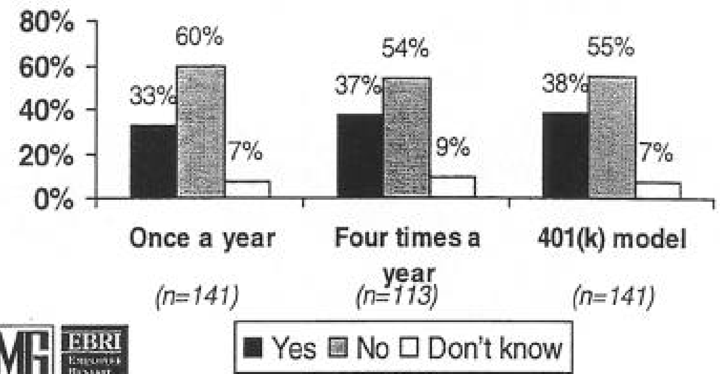
Amount Small Employers Are Willing to Spend (cont'd.)

Would you still favor this proposal if, in addition, Social Security taxes went up from 15.3% of taxable payroll to 17.3%?



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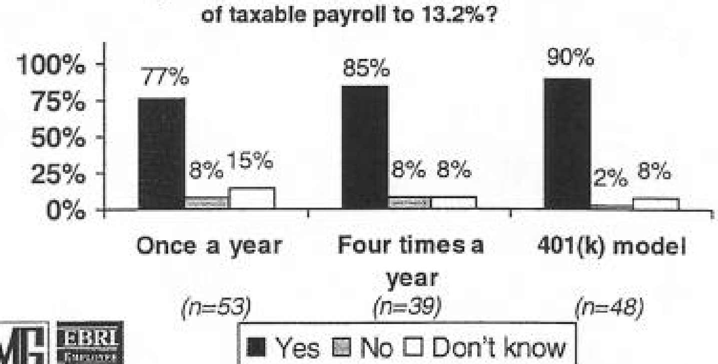
Amount Small Employers Are Willing to Spend (cont'd.)

Would you favor this system if the additional processing costs were offset by a reduction in Social Security taxes from 15.3% of taxable payroll to 13.2%?



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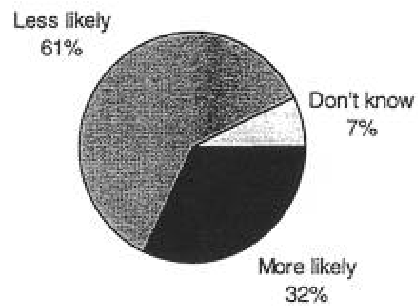
Support for Individual Accounts Reconsidered (cont'd.)

Would you say you are now more likely or less likely to favor it?

(n=105)



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[Whereupon, at 1:36 p.m., the Task Force was adjourned, subject to the call of the Chair.]